CONTRACT WITH AMERICA—SAVINGS AND INVESTMENT

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JANUARY 24, 25, 26, 31; AND FEBRUARY 1, 1995

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SUBMISSIONS FOR THE RECORD

TAX PROVISIONS IN THE CONTRACT WITH AMERICA DESIGNED TO ENCOURAGE SAVINGS AND INVESTMENT

TUESDAY, JANUARY 24, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

[The advisories announcing the hearings follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
January 6, 1995
No. FC-2

CONTACT: (202) 225-1721

ARCHER ANNOUNCES DETAILS ON SAVINGS AND INVESTMENT HEARINGS

-January 24, 25, 26, and 31-

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will conduct hearings on January 24, 25, 26, and 31, 1995, on the tax provisions in the *Contract with America* designed to encourage greater savings and investment. The Committee will receive testimony on the proposed American Dream Savings Account provision in the American Dream Restoration Act and tax cuts in the Job Creation and Wage Enhancement Act, which includes the proposed capital gains tax cut, neutral cost recovery, increased expensing for small businesses, increased estate tax unified credit, and improved home office deduction. The hearings will feature invited witnesses, Members of Congress, and public witnesses. **All hearings will begin at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.**

BACKGROUND:

The American Dream Restoration Act would create a new personal savings vehicle, the American Dream Savings Account (the "ADS Account"), effective for tax years beginning in 1996. Individuals could make non-deductible contributions up to $2,000 (married couples could contribute up to $4,000) annually to an ADS Account and could rollover amounts from a regular deductible IRA into an ADS Account. Distributions from an ADS Account used for retirement, first-time home purchases, educational expenses, and medical expenses would receive favorable tax treatment. Current-law, deductible IRAs would be retained.

The Job Creation and Wage Enhancement Act contains several proposals to encourage savings, investment, and entrepreneurship. First, the Act includes three capital gains incentives: (1) a 50 percent capital gains deduction, (2) indexation of capital gains basis to eliminate inflationary gains, and (3) a capital loss deduction for homeowners who sell their homes at a loss. The 50 percent capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1995, and the capital gains indexation would apply to inflation (and sales of assets) occurring after December 31, 1994. Second, the Act contains a "neutral cost recovery" proposal. Effective for eligible property placed in service on or after January 1, 1995, the proposal would increase depreciation deductions to approach the economic equivalent of expensing. Third, the Act would allow small businesses to "expense" (*i.e.* deduct in the year of purchase) up to $25,000 of property annually (current law limits expensing to $17,500). Fourth, the Act would phase in an increase in the estate and gift tax exemption to $750,000 and index the exemption. The current $600,000 exemption has not been increased in several years and has been eroded by inflation. Fifth, the Act would clarify the tax laws to allow greater deduction of expenses arising from a taxpayer's use of an office in his or her home. Sixth, the Act would let taxpayers allocate up to 10 percent of their tax liability to a public debt reduction fund. The designated funds would be strictly earmarked for national debt reduction and would be enforced through automatic spending cuts.

Archer stated, "There is no question that we should provide greater incentives for people to save and invest. These provisions contained in the *Contract with America* will go far in helping people to achieve these goals."

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearings must be made by telephone to Diane Kirkland, Traci Altman, or Richard Scott, (202) 225-1721 no later than the close of business, Thursday, January 12, 1995. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the staff at (202) 225-1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later 48 hours before hearings.**

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Friday, February 3, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

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ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
January 20, 1995
No. FC-3

CONTACT: (202) 225-1721

ARCHER ANNOUNCES ADDITIONAL DAY OF HEARINGS
ON SAVINGS AND INVESTMENT PROPOSALS

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will conduct an additional day of hearings on Wednesday, February 1, 1995, on the tax provisions in the *Contract with America* designed to encourage greater savings and investment. In response to significant interest on the part of the public in testifying on these issues, this additional day of hearings has been scheduled in order to accomodate as many witnesses as possible. Only members of the public who, in accordance with prior press releases, have requested to be heard and have been contacted by the Committee, will be scheduled to testify on February 1. Other interested members of the public are invited to submit written statements for the record of these proceedings. **The hearing will begin at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.**

All other details for the hearings remain the same. (See full Committee Advisory No. FC-2, dated January 6, 1995.)

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Chairman ARCHER. Good morning. Today we begin the last phase of our hearings on the tax proposals in the Contract With America. Last week we focused on what we can do within the Tax Code to strengthen families, and for the next 5 days of hearings we are going to be considering parts of the Contract that will increase savings and investment and protect existing savings.

One of the biggest threats to our economic security is that we don't save enough in America. I think every economist agrees about this whether they are liberal, moderate or conservative. The one thing we all know for sure is we don't need any efficient incentives for consumption. I think that if every one of us on the dais were willing to publicly show his or her wallet you would find at least one or more credit cards enclosed therein. So we are well along the road for consumption but are woefully weak in savings.

Many people talk about the incentive for new savings but few speak to the need to retain existing savings, amounts that have already been put aside at sacrifice and on which taxes have already been paid. Those savings need to be retained wherever they are in order to secure tools and technology to increase productivity and thereby increase the opportunity of American workers to have higher real wages. So that is what we will talk about in the next 5 days of hearings.

Our tax laws have a lot to do with whether we consume or whether we save. We must remove the disincentives to the greatest degree possible in the current tax law. We must also I believe in the long term find a method of raising money to pay for the government's bills that will reduce even further the disincentives to savings and create an agenda for the next century where we will become the economic juggernaut in a competitive world marketplace. That is where our future lies. This is not just the future of this country, but whether or not American workers will have the opportunity to realize their dreams of a better standard of living for their family, higher real wages, and an opportunity for their children to improve their economic lot in life.

But for now we must focus on the Contract With America. Later in the year I plan to hold hearings on alternative forms of taxation to replace the current income tax. Just as every blueprint is subject to modification, we welcome any constructive comments on how we can improve the basic provisions of the Contract.

I must say, though, I am not interested in hearing testimony as to how we can preserve the status quo. I don't want to hear why we can't make the Tax Code more friendly for savings and investment. I want to hear suggestions as to how we can do it. And I look forward to what our witnesses have to say as they present their testimony today and in the colloquy with our members.

[The prepared statement follows:]

Opening Statement of Chairman Bill Archer
Hearings on Savings and Investment Provisions in the Contract with America
January 24, 1995

Today we begin the last phase of our hearings on the tax proposals in the Contract with America. Last week, we focussed on the tax provisions to strengthen the American family. Over the next five days of hearings, the Committee will examine in detail the provisions in the Contract designed to encourage greater savings and investment.

One of the biggest threats to our long-term economic security is that Americans as a whole don't save enough.. Without savings, a person cannot buy a house, a business cannot purchase new equipment, and our economy cannot create jobs. Unless we can raise our national savings rate, our standard of living and our children's and grandchildren's standards of living will not grow.

Our savings rate is important, and it's not because we want to win some statistical game with other nations. We want to create jobs in this country, and high paying jobs at that. Low savings means less capital is available to a business that wants to expand and hire new workers or invest in new technology to make its workers more productive.

Why is our savings rate so abysmally low? If you look at our tax laws, you will see a large reason why. Instead of encouraging people to save, the tax code often punishes people who save and invest.

The issue is not just whether we need to create more tax incentives to encourage people to save and invest; it's how do we reduce the current disincentives residing in the tax code. I think you'll find few defenders of our current tax code. It encourages consumption. It erects barriers to savings and investment.

From a long-term standpoint, we have got to look at alternative tax systems, systems more suited to our economic goals. I intend to have this Committee seriously examine alternative tax systems after we finish with the Contract with America.

But that's the long-term plan. In the short-term, we have to dismantle some of the barriers Congress has erected in the Tax Code. That's the real issue we will be examining in these hearings. The question I want all of us to ask ourselves is What is the fairest and most efficient way to increase savings and investment in this country.

The provisions in the Contract with America will be our blueprint. Of course, a blueprint often is modified upon closer inspection, and I welcome any constructive comments on how we can improve these basic provisions. However, I am not interested in hearing people defend the status quo. I don't want to hear why we can't make the tax code more friendly for savings and investment. I want to hear how.

I look forward to what our witnesses have to say about increasing savings and investment and creating more economic opportunity for all Americans.

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Chairman ARCHER. I now recognize Mr. Matsui to make an opening statement on behalf of my Democrat colleagues.

Mr. MATSUI. Thank you, Mr. Chairman.

I think we, as you stated in your opening statements, do favor savings and investment as well. In fact, back in 1986 during the tax reform debate, President Reagan and Chairman Rostenkowski and Senator Packwood, then chairman of the Finance Committee, all supported tax reform, the idea to lower rates, and at the same time make sure that we had a more efficient economy where investments would be placed based upon good business judgment rather than tax incentives. So we also favor efficiency in the Tax Code.

I might just point out that the important issue over the next few months is the issue of getting the deficit under control. In fact, this week we in the House of Representatives will be voting on a balanced budget amendment. I presume it will pass, although at this time I understand there is some uncertainty as to what form it will take.

Back in 1983, Democrats essentially passed a $500 billion deficit reduction package based over a 5-year period. Back in 1990, with the assistance and leadership of President Bush, we reduced the budget deficit by $500 billion. At this time, we have the deficit on an annualized basis about 23 percent of the total GDP in this country.

Many economists say that that is a sustainable deficit, one that we can live with to promote growth in the economy, but we know that the deficit will be rising in years ahead mainly because of entitlement programs which many people have taken off the table in terms of spending cuts. So Democrats want to work with the American public, the business community, and our colleagues.

On the matter of how we are going to pay for these tax cuts, over the next 10 years, according to Treasury Department numbers, the 13 tax cuts in the Contract With America will cost $725 billion—$215 billion will be the cost over the next 5 years and $725 billion will be the cost over the next decade.

The cost increased from years 6 to 10 because that is when the capital cost recovery and that is when the issue of the capital gains tax kicks into place. So we want to make sure that if in fact we embark upon these tax cuts, we have spending cuts in place, certain spending cuts in place before we embark upon these tax incentives.

Let me mention, the Chairman had mentioned when we were debating the Kennelly amendment on the adoption of the rules that he is going to use discretionary spending cuts to pay for tax cuts. In the past, as the Chairman and other members know, we had a tradition in our committee that only revenue offsets would occur within this committee; that is, entitlement spending cuts would occur for tax cuts themselves.

The danger we face when we use discretionary spending cuts is, let's say that we want to cut the space program $3.5 billion over 5 years and then we give a tax cut of $3.5 billion over 5 years to replace that spending cut. The tax cut will continue on from years 6 to 10 into the definite future. The spending cut will end at the end of 5 years and that means that we will really not pay for it even though, under our budget rules, there will be a revenue neutral package. That is the danger of using discretionary spending cuts and we ought to be aware of this as we embark upon this quest.

Let me conclude by making one additional observation. There is always a fear, and we hope to hear from witnesses over the next 5 days on this, that the combination of the neutral cost recovery and the capital gains provisions will lead to tax shelters.

As you know, the reason the American public and President Reagan supported the issue of tax reform in 1986 was because tax shelters became a way of life, they became a way of avoiding the Tax Code, converting ordinary income into capital income. We need to make sure that this doesn't happen in this series of tax cuts.

Ultimately, the American public will want interest rate stability and interest rate reduction, but a business individual and a corporation makes judgments based upon how they should invest their capital. It is not just capital gains or capital cost recovery; it is a business climate and it is interest rates. That is what determines how people make business decisions. So we must make sure that we don't do damage to the economy which, at this particular point in time, is running at a reasonably even pace.

So we look forward to working with the Chairman and members of the other side of the aisle and certainly with the business community on achieving capital recovery and growth in the economy.

Thank you, Mr. Chairman.

Chairman ARCHER. Would our first panel of witnesses please take their seats at the witness table. Mr. Bloomfield, Dr. Sinai, Mr. Cohen.

Without objection, any other opening statements may be entered by individual members in the record.

[The opening statement of Mr. Ramstad follows:]

OPENING STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, thank you for compiling another excellent panel of witnesses for today's hearing on the "Contract With America."

I am extremely pleased that today's hearing focuses on the critical issue of savings and investment. Clearly, Americans must be relieved of the heavy Federal tax burden they now shoulder and be encouraged to put more of their income into savings.

We are all too familiar with the alarming data concerning our Nation's saving rate. The U.S. household saving rate compares miserably to that of our partners in the Group of Seven industrialized nations (G–7). In 1993, the U.S. household saving rate was just half that of the next lowest G–7 member, at 4.4 percent.

The Contract With America directly attacks this national problem by allowing Americans to keep more of what they earn and by encouraging them, through tax policy, to save more of their earnings.

Today's hearing will give us an opportunity to ask some of the leading experts on these matters how the provisions in the Contract will affect the ability and propensity of the American family to save more.

I thank you all for being here and I look forward to your testimony.

Chairman ARCHER. Gentlemen, again, welcome.

Mr. Bloomfield, you are our first witness. As president of the American Council for Capital Formation, we are delighted to have you with us this morning. I note in reviewing your testimony that you have also prepared special reports for this hearing, questions and answers on capital gains, questions and answers on IRAs, and the impact of the alternative minimum tax on investment and economic growth. I found these reports to be very useful and commend them to my colleagues.

You may proceed. You probably know the rules of the committee, that we would like you to keep your oral testimony to 5 minutes or less. Any lengthier testimony in writing may be submitted for the record.

STATEMENT OF MARK A. BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION; ACCOMPANIED BY MARGO THORNING, PH.D., CHIEF ECONOMIST

Mr. BLOOMFIELD. Mr. Chairman, thank you. For the record, I am Mark Bloomfield, president of the American Council for Capital Formation, and I am accompanied by Dr. Margo Thorning, our chief economist.

Today history has come full circle. Almost 17 years ago, July 25, 1978, a member of this committee with bipartisan support offered a proposal to index capital gains for inflation. It passed the committee. Unfortunately, it did not become law. Today it is in the Chairman's mark. The author of that proposal in 1978 was Congressman Bill Archer and the chairman today is Chairman Bill Archer. We congratulate you, Chairman Archer, and urge its enactment. It is long overdue.

Today I would like to make three points. First, we have a very serious savings and investment problem. U.S. savings and investment today lags behind those of our major competitors and our historic past. We need to do something about our low savings and investment.

Second, current tax policy is impeding savings and investment. The basic point here is that we tax savings and investment as if it were a sin rather than the important determinant of economic growth, higher living standards and better jobs for our citizens. Let me illustrate.

In our international survey of the taxation of personal savings, we found that the United States ranks at the top of 12 countries that most harshly tax personal savings, capital gains interest, and dividends. In our international comparison of the tax treatment of investment in machinery and equipment that is technologically innovative and that is crucial for economic growth as well as pollution control equipment, we again found that the United States taxes investment much more harshly than our competitors.

Although the Tax Reform Act of 1986 reduced corporate and individual tax rates, it unfortunately increased capital costs by eliminating the investment tax credit, lengthening depreciation lives, creating the comprehensive corporate alternative minimum tax and increasing capital gains tax rates. These are the issues that the Contract now seeks to redress.

Third, the GOP Contract. There are three savings and investment provisions that are an important step in reducing the bias against capital formation, provided that the Contract does so in such a manner as to be revenue neutral in the aggregate and does not increase the deficit.

Neutral capital cost recovery (NCRS). While true expensing would be preferable, NCRS is a positive step toward real expensing for investment and it ameliorates some of the negative impact of the alternative minimum tax on new investment.

IRAs. We believe IRAs are a very useful tool to increase our dismally low personal savings rate. Let me respond to the criticisms of IRAs. Do IRAs result in new savings? I think the answer is yes. The weight of available evidence suggests that IRAs generated a significant amount of savings that otherwise would not have taken place.

Second, can we afford expanded IRAs? Again. I think the answer is yes. Harvard Professor Larry Summers, who now serves as the Under Secretary of the Treasury explained, under current law, the government loses 25 cents for each dollar of IRA contribution. If more than one quarter of new saving going to IRAs represents new savings, IRAs will increase private saving by more than their revenue cost.

Capital gains tax reductions. Treasury Secretary Robert Rubin suggested that the President could sign a capital gains tax cut if it met three criteria: That it made economic sense, that it was fair and that it did not lose revenue. Let me expand. First, it would make economic sense if it reduces our high capital costs, if it prevents the taxation of inflationary gains, and if it encourages entrepreneurship.

Second, it would be fair if it applies to all income brackets and all sectors of the American economy, to Main Street as well as Wall Street, to middle-class investors as well as farmers, to new entrepreneurs as well as retiring businessmen, and to individuals and corporations.

Third, it should not reduce total tax revenues and should in fact be a revenue raiser because of the unlocking of existing assets and important macroeconomic consequences. On all three counts, I suggest the capital gains proposals in the Contract measure up to Secretary Rubin's criteria and therefore should be enacted into law.

Conclusion. The pendulum may be about to swing from the tax policies of the last decade, especially the substantial increase in the economic tax burden on savings and investment and back toward progrowth policies. When historians in years ahead judge this committee, let its legacy be that it was the savings and investment Committee on Ways and Means.

Thank you.

[The prepared statement and attachments follow:]

ACCF

AMERICAN COUNCIL FOR CAPITAL FORMATION

Statement of
Mark A. Bloomfield, President
American Council for Capital Formation
before the House Committee on Ways and Means
January 24, 1995

ACCF STATEMENT

My name is Mark A. Bloomfield. I am president of the American Council for Capital Formation (ACCF). I am accompanied by Dr. Margo Thorning, our chief economist. The ACCF represents a broad cross section of the American business community, including the manufacturing and investment sectors, Fortune 500 companies and smaller firms, individuals, and associations. Our board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders and public finance experts. We appreciate this opportunity to present testimony on the impact of the tax provisions in the Republican "Contract With America."

To encourage a constructive debate on the Contract's saving and investment proposals, our affiliated public policy think tank, the ACCF Center for Policy Research, has prepared three special reports for today's hearing: "Questions and Answers on Capital Gains," "Questions and Answers on IRAs," and "The Impact of the Alternative Minimum Tax on Investment and Economic Growth."

We commend the emphasis the GOP Contract places on the need to increase saving and investment. The saving and investment proposals: the Neutral Cost Recovery System (NCRS), capital gains tax reductions, and expansion of Individual Retirement Accounts (IRAs) in the GOP contract will, if enacted, go a long way toward addressing the burdens on capital formation imposed by the Tax Reform Act of 1986 (TRA). Almost ten years after the enactment of the TRA, it is clear that U.S. tax policies toward saving and investment must be revised if we are to increase real wages for U.S. workers and retain our leading role in world affairs. We also applaud Chairman Archer and members of this committee for their commitment—which we share—to enacting the Republican Contract in such manner as to be revenue neutral in the aggregate, thus not increasing the federal deficit.

TRENDS IN U.S. CAPITAL FORMATION

Investment spending in the United States in recent years compares unfavorably with that of other nations as well as our own past experience. From 1973 to 1991, gross nonresidential investment as a percent of Gross Domestic Product (GDP) was lower for the United States than for any of our major competitors (see Table 1). The U.S. saving rate averaged 4.8 percent over the 1973-1991 period, compared to 19.1 percent in Japan and 10.7 percent in West Germany. Even more disturbing is the fact that net annual business investment in this country has in recent years fallen to only half the level of the 1960s and 1970s. Net private domestic investment averaged 7.4 percent of GDP from 1960 to 1980; since 1991 it has averaged only 3.0 percent (see Table 2).

Reflecting the reduced share of GDP being invested each year, the U.S. capital stock has also grown more slowly. In the three decades prior to 1980, the total capital stock grew at 4.0 percent per year; in the 1980s and 1990s, the rate fell to 2.7 and 1.4 percent respectively (see Table 3). The stock of equipment, which many experts regard as critical for strong productivity growth, has increased only about half as fast since 1980 as in previous decades. Industrial equipment stocks, which grew at an average rate of 4.3 percent over the 1950-1979 period, increased by just 1.2 percent annually in the 1980s and 0.1 percent since 1990.

LINK BETWEEN INVESTMENT, PRODUCTIVITY INCREASES, AND ECONOMIC GROWTH

The importance of investment in plant and equipment for economic growth is emphasized in a new book by Harvard Professor Dale Jorgenson. Professor Jorgenson's book, *Productivity: Postwar U.S. Economic Growth*, analyzed economic growth between cyclical peaks in the business cycle over the 1948-1979 period. Allocating increases in output to three sources, growth in the capital stock labor, supply, and multifactor productivity, Professor Jorgenson found that increases in the capital stock contribute most to increases in output (see Figure 1).[1]

In 1979, the output of the civilian economy stood at almost three times the level of output in 1948. Capital and labor inputs together contributed 2.6 percent per year to the output growth rate of 3.4 percent from 1948 to 1979; capital's share was 1.5 percent compared to 1.1 percent for labor. Thus, these two inputs accounted for more than three-fourths of output growth, Professor Jorgenson stated. By contrast, multifactor productivity increases (efficiency gains) during this period contributed 0.8 percent per year, or only 24 percent of output growth. Growth in capital input is the most importance source of growth in output, growth in labor input is the next most important source, and multifactor productivity growth plays a subordinate role, Professor Jorgenson concluded.

Studies by Harvard Professors Bradford De Long and Lawrence H. Summers, now on leave at the U.S. Department of the Treasury, concluded that investment in equipment is perhaps the single most important factor in economic growth and development. Their research provided strong evidence that for a broad cross section of nations, every 1 percent of GDP invested in equipment is associated with an increase in the GDP growth rate itself of one-third of one percent—a very substantial social rate of return.

Investment's key role in advancing technological progress and productivity growth is also stressed in recent research by New York University Professor Edward N. Wolff. He argued that U.S. labor productivity growth rates are depressed by the recent slower growth in the capital-to-labor ratio—from a peak of 2.0 percent per year in the 1950s to 1.2 percent per year in the 1972-1992 period. He emphasized that the effects of the decline in U.S. capital-labor growth are perhaps even more pernicious than they appear at first glance. First, an increasing capital-labor ratio will increase labor productivity through capital deepening. Second, there appears to be an important and significant interaction effect between capital investment and technological advance.

Thus, a slowdown in capital formation may doubly hurt labor productivity growth—directly by slowing down the rate of capital deepening and indirectly by slowing down the rate of technological advance. His research also shows that U.S. labor productivity growth lags behind our competitors; OECD countries outstripped the United States during much of the 1950-1990 period. He noted that countries such as Japan and Germany, which experienced strong productivity growth in the 1970s and 1980s, showed significant gains in their capital-to-labor ratios. Our competitors' gains in capital-to-labor ratios are a direct result of their higher levels of investment.

IMPLICATIONS OF LAGGING INVESTMENT AND SLOW GROWTH IN LABOR PRODUCTIVITY FOR CURRENT AND FUTURE LIVING STANDARDS

Real family income in the United States has been nearly stagnant since the mid-1970s and in recent years has actually fallen. For example, real median household income was $39,869 in 1989; income has declined in each subsequent year, and in 1993, stood at $36,959. These trends have not only made it harder to maintain living standards but have also jeopardized our future economic health and our ability to remain the principal leader in international affairs. In addition, looming in the future is the need to finance the retirement of the baby boom generation. Research by Stanford Professor B. Douglas Bernheim, commissioned by the ACCF Center for Policy Research, our public policy think tank, shows that current saving by members of the baby boom generation is seriously inadequate. The typical baby boom household saves at only one-third the rate required to finance a retirement standard of living comparable to that enjoyed before retirement.

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[1]Jorgenson's analysis uses *multifactor* productivity, which relates output to inputs of both labor and capital. The traditional productivity measure commonly found in popular articles is *labor* productivity, which relates output to labor input alone.

TAX POLICY AND CAPITAL COSTS

The user cost of capital is the pretax return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, inflation, risk, economic depreciation, and taxes. This capital cost concept is often called the "hurdle rate" because it measures the return an investment must yield before a firm will be willing to start a new capital project.

Economists are in broad agreement that capital costs are affected by tax policy. For example, Stanford Dean John B. Shoven estimated that about one-third of the cost of capital is due to taxes. In other words, hurdle rates are 50 percent higher than they would otherwise be due to the tax liability on the income produced by the investment. Thus, the higher the tax on new investment, the less the investment that will take place. Although TRA substantially reduced corporate and individual income tax rates, the legislation's capital cost recovery provisions raised effective tax rates and capital costs for productive and pollution-control assets. Capital costs increased because of the loss of the investment tax credit, lengthening of depreciable lives for many assets, creation of the corporate alternative minimum tax (AMT), and increases in the capital gains tax.

The corporate AMT has an especially pernicious effect on the cost of capital. TRA created a comprehensive AMT system separate from, but parallel to, the regular tax system. Under the AMT regime, taxable income is modified by an intricate series of "adjustments" to income, including depreciation. A high level of investment is a major reason firms become AMT taxpayers. Depreciation allowances for firms paying the AMT generally are much less favorable than for those for firms paying the regular corporate income tax (see Table 4). Today, a significant proportion of large U.S. companies pay the AMT rather than the regular income tax. Yet a high level of investment is exactly what is needed for increasing economic growth; thus, AMT reform should be given high priority. (For additional background, see "The Impact of the Alternative Minimum Tax on Investment and Economic Growth," a special report prepared by the ACCF Center for Policy Research for this hearing.)

The impact of TRA on U.S. industry can be illustrated by the following example relating to the present value of the capital cost recovery allowance when a corporation purchases new equipment. For example, the present value of the deductions for investment in modern and competitive continuous casting equipment for steel production under the strongly pro-investment tax regime in effect from 1981 to 1985 was close to 100 percent, according to a study by Arthur Andersen & Co. prepared especially for today's testimony. In contrast, under current law the present value of the capital cost recovery allowance for that same investment today is only 81 percent for a corporation paying the regular income tax. And if a corporation is subject to the corporate AMT, as many major steel companies are, the present value is only 59 percent (see Table 4).

The Arthur Andersen study also shows that the United States lags behind many of our major competitors in capital cost recovery for equipment that is technologically innovative, is crucial to U.S. economic strength, or helps prevent pollution. Capital cost recovery provisions for pollution-control equipment are much less favorable now than prior to TRA's passage. For example, the present value of cost recovery allowances for wastewater treatment facilities used in pulp and paper production was approximately 100 percent prior to TRA. Under regular TRA income tax, the present value for wastewater treatment facilities dropped to 81 percent; for AMT payers, the figure became 63 percent. Scrubbers used in the production of electricity fared even worse. Prior to TRA, the present value was 90 percent. Today, the present value is only 55 percent; for AMT taxpayers the figure drops to 42 percent. As is true in the case of productive equipment, loss of the investment tax credit and lengthening of depreciable lives both raise effective tax rates.

According to estimates by Dr. Joel Prakken of Laurence H. Meyer & Associates, the user cost of capital for most types of productive equipment would now be about 15 percent lower had TRA not been enacted (see Figure 2).

THE REPUBLICAN CONTRACT AND U.S. ECONOMIC GROWTH

Reforming and restructuring the U.S. federal tax system to reduce the multiple taxation of saving and investment inherent in the income tax—and promoting investment and higher living standards—is high on policymakers' 1995 agenda. The saving and investment proposals in the "Contract With America" will, if enacted, go a long way toward addressing the burdens on saving and investment imposed by TRA.

- *Neutral Capital Cost Recovery (NCRS)*

The Republican Contract's proposal to increase depreciation deductions to allow the theoretical equivalent of expensing—i.e., immediate write-off—for property with recovery classes of ten years or less, and to index longer-lived property for inflation will be important steps forward in reducing the bias against saving and investment for firms paying the regular income tax.

Under NCRS, the present value of capital cost recovery allowances of, for example, assets used to produce continuous casting equipment for steel production, rises from 81 percent under current law to 95 percent, not far below the equivalent to expensing (see Table 4). Firms paying the AMT also fare much better under NCRS. For example, the present value of depreciation allowances rises to 93 percent for equipment used for producing continuous casting equipment, compared to 59 percent under current law.

However, short-lived equipment comes closer to the ideal of expensing under NCRS than do assets with recovery classes longer than ten years. For example, net present value for scrubbers used in electricity plants would rise from 55 percent under current law to only 69 percent under NCRS (Table 4). Thus NCRS does not provide a "level playing field" among assets with short and long lives. Another possible drawback to NCRS is that cash flow for short-lived assets is reduced in the early years of an assets' life due to the switch from 200 percent declining balance method of depreciation to the 150 percent method. However, the fact that NCRS is voluntary and can be elected on an asset-by-asset basis should minimize this concern for companies that tend to give more weight to cash flow compared to net present value's in evaluating investment projects.

The ACCF has long advocated expensing as the optimal way of leveling the playing field for all types of assets. While true expensing, which would allow in the first year a complete write-off for the purchase price of an asset is preferable in many ways to NCRS, such an expansive change in tax policy may not be affordable at present.

In sum, NCRS is a positive move toward real expensing for investment and ameliorating much of the AMT's negative impact on new investment.

- *Capital Gains Tax Reductions*

The GOP "Contract With America" contains three capital gains incentives. First, individual and corporate taxpayers could exclude 50 percent of their capital gains from taxable income. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending on the tax bracket. Corporations would be subject to a top effective capital gains tax rate of 17.5 percent. Second, the basis (the original cost) of capital assets would be indexed for inflation occurring after 1994. Third, individual taxpayers could deduct losses on sales of principle residences.

Capital gains tax reform should satisfy three criteria. First, it should make economic sense by lowering the excessively high cost of U.S. capital, reducing the bias against high-risk capital, and ameliorating the taxation of inflationary gains. Second, it should be fair to all income groups and sectors of the U.S. economy: Main Street and Wall Street, middle-class investors and farmers, new entrepreneurs and retiring businessmen, and individual investors and businesses alike. Third, it should not reduce total tax revenues and, in fact, it might be a revenue-raiser because it would unlock existing capital gains and would have important macroeconomic consequences.

On all three counts, the capital gains proposal in the Republican Contract measures up and should be enacted. (This is further documented in "Questions and Answers on Capital Gains," a special report prepared by the ACCF Center for Policy Research for this hearing.)

To those who favor a truly level playing field over time for individual and business decisions to save and invest, stimulate economic growth, and create new and better jobs, capital gains (and other forms of saving) should not be taxed at all. This view was held by top economists in the past and is held by many mainstream economists today.

This is primarily because the income tax hits saving more than once—first when income is earned and again when interest and dividends on the investment financed by saving are received, or when capital gains from the investment are realized. The playing field is tilted because the individual or company that saves and invests pays more taxes over time than if all income were consumed and no saving took place. Taxes on income that is saved raise the capital cost of new productive investment for both individuals and corporations, thus dampening such investment. As a result, future growth in output and living standards is impaired.

Low capital gains taxes not only treat savers more fairly but also help hold down capital costs. Public finance economists refer to the tax on capital gains as a tax on retained income, which funds a large part of business investment. The higher the capital gains tax, the more difficult it is for management to retain earnings (rather than pay out dividends) to fund real investment in productive projects. Research by Stanford Dean John Shoven, Ohio State Professor Patric Hendershott, and Dr. Allen Sinai, chief global economist at Lehman Brothers and a highly respected economic forecaster, indicates that a cut in the capital gains tax rate to a range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent.

Favorable tax treatment of capital gains is especially important in encouraging the "start-up" of new but risky enterprises, which provide significant dynamism and growth to the U.S. economy. Much of that start-up money comes from friends and relatives of the entrepreneur. Most of their return is likely to be in appreciated stock; thus, low capital gains taxes makes them more willing to risk their savings.

Dr. Sinai's research in the past has shown that when macroeconomic "feedback" effects as well as unlocking of unrealized capital gains are estimated, a substantial reduction in capital gains taxes results in new and better jobs, as well as increased capital formation, stronger economic growth, and federal tax revenues that are significantly larger than under current law.

Specifically, capital gains tax reductions would:

- raise real and nominal gross national product,
- increase capital spending and capital formation,
- increase employment,
- raise stock prices,
- increase household net worth,
- lower the cost of capital for business and increase business profits,
- shift business financing from debt to equity,
- draw a larger portion of household investment in to equities,
- shift the financing of business activity away from debt to equity, and
- induce portfolio allocations by households toward equity.

- *Individual Retirement Accounts*

Individual Retirement Accounts (IRAs) were developed in the 1970s to encourage individuals to save for retirement. The 1981 tax cut expanded IRAs so that any wage earner could contribute up to $2,000 annually to an IRA; a couple with two wage-earners could contribute $4,000. A couple with a nonworking spouse could contribute $2,250. Contributions were tax deductible and taxes on funds accumulating in an IRA were deferred until withdrawn. Individuals had to be 59 1/2 years of age to withdraw funds from IRA accounts without penalty.

TRA curtailed IRAs so that contributions are not fully deductible except for workers without employer pensions, families with annual incomes under $40,000, and individuals with annual incomes under $25,000. These income limits are not indexed.

The Republican "Contract With America" offers a new "American Dream Savings Account" (ADS) which allows a nondeductible annual contributions of up to $4,000 for a married couple ($2,000 for an individual) and provides indexation for inflation. If the ADS were held for five years, the taxpayer could withdraw funds without penalty for retirement, first-time home purchases, and college or medical expenses.

IRA reform enjoys bipartisan support. For example, President Clinton has also proposed such reform, expanding tax-deductible IRAs as part of his "Middle-Class Bill of Rights" and permitting the use of the money before retirement to pay for the purchase of a first home, education, catastrophic health costs, or the care of an elderly parent. The Administration proposal raises the current tax-deductible IRA income limit from $40,000 (phasing out at $50,000) to $80,000 (phasing out at $100,000). The Administration proposal also allows individuals the option of the "back-loaded IRA" in which after-tax saving is put into an IRA but the proceeds are exempt from tax when withdrawn.

Prominent public finance economists and scholars such as former Council of Economic Advisers Chairman Martin Feldstein, Treasury Undersecretary Lawrence H. Summers, and Professors David A. Wise of Harvard University, James M. Poterba of Massachusetts Institute of Technology, Steven F. Venti of Dartmouth College, Jonathan Skinner of the University of Virginia, and Richard A. Thaler of Cornell University have concluded that IRAs—especially tax-deductible IRAs—do in fact result in new saving.

Nearly a dozen scholarly studies, using a variety of data sources and employing several different statistical approaches, have examined whether targeted saving vehicles such as IRAs and 401(k)s affect saving. For example, Professor Venti's recent testimony before a Senate Finance Subcommittee examined saving data from a Survey of Income and Program Participation for three different age groups (families reaching age 60 to 64 in 1984, 1987, and 1991). Professor Venti found a striking increase in saving the longer the family has been exposed to the targeted retirement programs—IRAs, 401(k)s, and Keoghs (see Table 5).

The growth in IRA and 401(k) asset balances is astounding, Professor Venti noted. The typical member of the youngest family—those with nine years of exposure to targeted retirement saving programs—has nearly three times the targeted retirement assets of the oldest cohort. There is a comparable increase in total assets as well. In contrast, among families without IRAs, 401(k)s, and Keoghs, the youngest families have only about 75 percent of the financial assets of the older families ($1,691 vs. $2,247). Professor Venti concluded that since total financial assets, including balances in IRAs and 401(k)s, were much larger for the younger cohort (the families with the longest exposure to IRAs) in 1991 than for the older cohort in 1984, targeted retirement saving programs did stimulate new saving over the period.

Another reason that IRAs can be an important tool in increasing the low U.S. saving rate is that they encourage the self-control required to abstain from consumption. According to Professor Thaler, IRAs help people save by making it more difficult to "get to" the money than if it were left in an open bank savings or checking account. Professor Thaler explains that households allocate funds, implicitly or explicitly, into categories, or "mental-accounts." Some funds—for example those in cash or a checking account—are designated for current consumption. Others—for example those in a savings account—are for "rainy days" or "special occasions." Self-control and mental-accounts come together because the latter vary in how "tempting" they are to invade. Money in a person's wallet is more tempting to spend than money in the checking account, which in turn is more tempting than the savings account. Less tempting are funds explicitly set aside for retirement, such as money in an IRA plan. Once this concept is factored in, IRAs can increase saving even if (as some critics charge) all the money put into IRAs would have been saved anyway. By putting funds into a less accessible account, the IRA increases long-term saving. (For additional background on IRAs, see "Questions and Answers on IRAs," a special report prepared by the ACCF Center for Policy Research for this hearing.)

Conclusion

The pendulum may be about to swing away from the tax policies of the last decade, especially the substantial increase in the economic tax burden on saving and investment, and back toward progrowth policies. The hard fact is that we can no longer afford the luxury of tax policies that reward consumption, discourage saving and investment, overregulate American business, and penalize economic growth.

The Republican Contract's tax reform proposals for neutral capital cost recovery, capital gains tax reductions, and IRA expansion have started a dialogue that is likely to result in a substantial reduction in the bias against saving and investment in the U.S. tax code. These provisions would help move the United States toward a tax system that is more neutral toward productive capital formation and pave the way for more fundamental tax restructuring.

Table 1 Saving and Investment as a Percent of Gross Domestic Product, 1973-1991

	United States	Canada	Japan	France	West Germany	United Kingdom
SAVING						
Net saving[1]	4.8%	8.1%	19.1%	8.8%	10.7%	4.7%
Personal saving[2]	5.9%	7.7%	11.9%	6.9%	8.2%	3.2%
Gross saving (net saving plus consumption of fixed capital)[3]	16.6%	19.7%	32.8%	21.2%	22.9%	16.2%
INVESTMENT						
Gross nonresidential fixed capital formation	13.9%	15.3%	24.1%	15.0%	14.7%	14.3%
Gross fixed capital formation	18.4%	21.7%	30.3%	21.1%	20.6%	18.0%

[1]*The main components of the OECD definition of net saving are: personal saving, business saving (undistributed corporate profits), and government saving (or dissaving). The OECD definition of net saving differs from that used in the National Income and Product Accounts published by the Department of Commerce, primarily because of the treatment of government capital formation.*
[2]*Personal saving is comprised of household saving and private unincorporated enterprise.*
[3]*The main components of the OECD definition of consumption of fixed capital are the capital consumption allowances (depreciation charges) for both the private and the government sector.*

Source: Derived from National Accounts, Vol. II, 1973-1985 and 1979-1991, Organization for Economic Cooperation and Development (OECD), 1987 and 1993 eds. Prepared by the American Council for Capital Formation Center for Policy Research, February 1994.

Table 2 Flow of U.S. Net Saving and Investment (percent of GDP in current $)

	Average 1960-1980	Average 1981-1985	Average 1986-1990	Average 1991-1994[1]
Net private domestic saving	8.2%	7.2%	5.1%	5.2%
State and local government surpluses	0.4%	1.2%	0.9%	0.4%
Subtotal of private and state saving	8.6%	8.4%	5.9%	5.6%
Less: federal budget deficit	-1.0%	-4.1%	-3.2%	-3.6%
Net domestic saving available for private investment	7.6%	4.3%	2.7%	1.9%
Net inflow of foreign saving[2]	-0.4%	1.2%	2.4%	1.1%
Net private domestic investment	7.2%	5.5%	5.1%	3.0%
Personal saving	5.1%	5.6%	3.4%	3.4%
Net business saving[3]	3.1%	1.6%	1.7%	1.8%

[1]*In the 1960-80 period the United States sent more capital abroad than it received; thus net inflow was negative during this period.*
[2]*Net business saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.*
[3]*The 1994 figures included in this average reflect only the first two quarters.*

Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, October 1994.

Table 3 Growth in the Net Capital Stock by Type (average annual growth rates in 1987 dollars)

	1950-59	1960-69	1970-79	1980-89	1990-93	1993 level (billions of 1987 $)
Total	3.6	4.5	3.8	2.7	1.4	4979.5
Equipment	4.1	5.0	4.9	2.6	2.3	2359.7
Information processing	8.8	8.9	8.9	9.3	7.3	747.7
Equipment less information processing	3.8	4.7	4.4	1.0	0.3	1612.1
Industrial[1]	5.0	4.3	3.6	1.2	0.1	754.6
Structures	3.3	4.2	2.8	2.8	0.6	2619.7

[1]*Industrial equipment includes fabricated metal products, engines and turbines, metal working machinery, special industry machinery, general industrial (including materials handing, equipment, and electrical transmission), distribution, and industrial apparatus.*

Source: "Fixed Nonresidential Private Capital, by Type of Equipment and Structures," Department of Commerce, Bureau of Economic Analysis, July 21, 1994. Chart prepared by the American Council for Capital Formation Center for Policy Research, September 1994.

Table 4 NCRS and [illegible] of [illegible] Value of Equipment Used to Make Selected Manufacturing Products [illegible] (as a percent of cost)

	Computer Chips	Telephone Switching Equipment	Factory Robots	Crank-shafts	Continuous Casting for Steel Production	Engine Blocks	Wastewater Treatment for Chemical Production	Wastewater Treatment for Pulp and Paper Equipment	Scrubbers Used in Electricity Plants
United States									
1985 Law	100.1	100.1	100.1	100.1	100.1	100.1	100.1	100.1	89.7
MACRS[1]	85.2	85.2	80.8	80.8	80.8	80.8	85.2	80.8	54.5
AMT[2]	81.1	78.4	68.8	64.6	59.0	60.8	70.0	62.7	41.5
NCRS[3]	95.4	95.4	94.9	94.9	94.9	94.9	95.4	94.9	68.9
AMT-NCRS[4]	95.4	95.2	94.2	93.8	93.0	93.3	94.3	93.5	61.1
Brazil	75.7	74.8	74.7	74.7	88.3	74.7	74.7	74.7	79.4
Canada	76.9	75.9	74.0	73.8	74.2	73.6	85.3	85.3	85.3
Germany	83.6	83.0	82.7	83.9	82.2	83.9	71.8	69.7	68.9
Japan	87.1	86.2	83.4	83.9	81.4	83.7	84.6	83.7	82.4
Korea (w/3% ITC)	88.7	84.3	82.6	80.1	77.7	79.6	95.2	93.9	92.2
Singapore	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7
Taiwan	83.9	78.0	79.0	64.3	63.5	63.7	147.0	147.0	147.0

Notes: [1]*MACRS* = *Modified Accelerated Cost Recovery System (Current Law)*
[2]*AMT* = *Alternative Minimum Tax (Current Law)*
[3]*NCRS* = *Neutral Cost Recovery System Proposal in Republican Contract for regular tax payers*
[4]*AMT-NCRS* = *AMT Reform in NCRS Proposal in Republican Contract for AMT payers*

Source: Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad is Bad." in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: American Council for Capital Formation Center for Policy Research, September 1991); and unpublished data incorporating the AMT provisions of OBRA 1993. Updated by Arthur Andersen LLP, Office of Federal Tax Services, Washington, D.C., January 1995.

Table 5 Financial Assets Saved by Families [illegible]

	Families reaching age 60-64 in: 1984	1987	1991
Percent of families with targeted retirement saving	38	41	42
Approximate years of exposure to plans	2	5	9
Targeted retirement assets	$7,575	$13,119	$21,613
Total financial assets	$29,847	$34,013	$45,019
Percent of families without targeted retirement saving	62	59	58
Total financial assets	$2,247	$1,982	$1,691

Note: The data on saving are median asset balances in 1991 dollars.

Source: Steven F. Venti, "Promoting Saving for Retirement Security," testimony presented to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994.

Figure 1 Sources of U.S. [illegible] Growth [illegible]

[1]The endpoints for each period are years in which a cyclical peak occurred. The growth rate is the average annual growth rate between cyclical peaks.

Source: Dale Jorgenson. *Productivity, Vol. I: Postwar U.S. Economic Growth*. (Cambridge, Mass.: MIT Press, 1995). Chart prepared by the ACCF Center for Policy Research, January 1995.

Figure 2. Cost of Capital for Equipment Less Computers

Note: The cost of capital is defined as the user cost of capital; it includes economic depreciation. Personal tax rates are not factored into the calculations.

Source: Joel Prakken, Laurence H. Meyer and Associates, unpublished data, August 1994.

AMERICAN COUNCIL FOR CAPITAL FORMATION
CENTER FOR POLICY RESEARCH

SPECIAL REPORT

January, 1995

Questions and Answers on Capital Gains

Q. *Does the United States Need a Capital Gains Tax Cut?*

A. Yes. To those who favor a truly "level playing field" over time for individual and business decisions to save and invest, stimulate economic growth, and create new and better jobs, capital gains (and other forms of saving) should not be taxed at all. This view was held by top economists in the past and is held by many mainstream economists today.

This is primarily because the income tax hits saving more than once, first when income is earned and again when interest and dividends on the investment financed by saving are received, or when capital gains from the investment are realized. The "playing field" is tilted because the individual or company that saves and invests pays more taxes over time than if all income is consumed and no saving takes place. Taxes on income that is saved raise the capital cost of new productive investment for both individuals and corporations, thus dampening such investment. As a result, future growth in productivity and living standards is impaired.

Low capital gains taxes not only treat savers more fairly but also help hold down capital costs. Public finance economists refer to the tax on capital gains as a tax on retained income, which funds a large part of business investment. The higher the capital gains tax, the more difficult it is for management to retain earnings (rather than pay out dividends) for real investment in productive projects.

Favorable tax treatment of capital gains is especially important in encouraging the "start-up" of new but risky enterprises, which provide significant dynamism and growth to the U.S. economy. Much of that start-up money comes from friends and relatives of the entrepreneur. Their return will be in appreciated stock and thus low capital gains taxes makes them more willing to risk their savings.

The unfairness of taxing capital gains is significantly increased in those cases in which gains are "phantom earnings" brought on by inflation. Indexation of capital gains taxes would obviate this.

Although the economy is expanding, worries about the future appear to be multiplying. A cut in the capital gains tax to a top marginal rate of, say, 15 to 20 percent would by no means act as an economic panacea. However, it would surely give a strong boost to values of capital assets (e.g., real estate and the stock market), encourage investment by both mature and new businesses, and constitute fairer taxation of peoples' savings.

Q. *Will Capital Gains Tax Cuts Increase U.S. Job Growth and Economic Growth?*

A. Yes. Dr. Allen Sinai, chief global economist at Lehman Brothers and a highly respected economic forecaster, argues that when macroeconomic "feedback" effects as well as unlocking of unrealized capital gains are estimated, a substantial reduction in capital gains taxes results in stronger economic growth, increased capital formation, and federal tax revenues that are significantly larger than under current law.

His estimates show that cuts in capital gains taxes:

- raise real and nominal gross national product,
- increase capital spending and capital formation,
- raise stock prices,
- increase household net worth,
- lower the cost of capital for business and increase business profits, and
- increase employment.

A capital gains tax reduction would also shift the financing of business activity away from debt to

For more information on capital gains issues, please contact the American Council for Capital Formation Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006-2300; 202/293-5811.

equity, and induce portfolio allocations by households toward equity to take account of changes in expected after-tax returns on stocks and bonds.

Q. How Do Capital Gains Affect Capital Costs?

A. The cost of capital is the pretax return of the new investment needed to cover the purchase price of an asset, the market rate of interest, inflation, taxes, and the return required by the investors. Capital costs are an important factor in determining which investments firms will make and how much investment occurs. High capital costs mean that only those projects with the greatest expected return will be undertaken because only they will yield a return large enough to satisfy investors, resulting in less overall investment and an aversion toward higher risk projects.

Research by Stanford's Dean of the College of Arts and Sciences, Professor John Shoven, Ohio State Professor Patric Hendershott, and Dr. Allen Sinai of Lehman Brothers indicates that a capital gains tax rate in the range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent.

Q. Aren't Cuts in Capital Gains Tax Rates Simply Another Version of "Trickle-Down" Economics that Won't Help Working Americans?

A. No. The econometric studies of Dr. Allen Sinai demonstrate that a cut in capital gains tax rates will begin quickly to promote jobs, growth, and investment. This is because the tax cut would lower business capital costs, increase start-ups of new companies, and raise the value of equities and real estate. This is precisely the sort of economic environment in which "working Americans" prosper.

Perhaps the best anecdotal answer to those who argue that high taxes on capital gains hurt working Americans comes from a New Jersey painting contractor who (as quoted in the *Washington Post*) was "trying to scare up some work..."

> "...you're looking at a poor man who thinks the capital gains tax [cut] is the best thing that could happen to this country because that's when the work will come back. People say capital gains is for the rich, but I've never been hired by a poor man."

Q. Still, isn't it True that Most of the Direct Benefits of a Capital Gains Tax Cut Go to the Rich?

A. No. The facts are that many middle-class taxpayers realize a capital gain every once in a while but are counted as permanently rich under IRS statistics. But when those tax payer returns are adjusted to exclude their temporary capital gains and include only their wage and salary income, it becomes clear that middle-class taxpayers are major beneficiaries of lower capital gains tax rates. A special Treasury study covering 1985 shows that nearly one-half of all capital gains were realized by taxpayers with wage and salary income of less than $50,000. In addition, three-fourths of all returns with capital gains were reported by taxpayers with wage and salary income of less than $50,000. The issue of counting as wealthy the middle-class person who occasionally realizes a capital gain which artificially inflates his income in a given year has been studied by the Joint Committee on Taxation. A panel analysis for the year 1979-1983, by the JCT, found that 44 percent of taxpayers reporting gains realized a gain in only one out of five years.

It is true that many upper-income people have large capital gains. By realizing them, they pay more taxes, making revenue available to finance government programs which benefit lower-income recipients.

Q. How Do Capital Gains Rates Affect "Start-Up" Companies?

A. Capital gains taxation has a particularly powerful impact on the entrepreneurial segment of the U.S. economy—making possible new technological breakthroughs, new start-up companies, and new jobs. Starting new businesses involves entrepreneurs, informal investors, venture capital pools, and a healthy public market. All are sensitive to after-tax rates of return, which is why the level of capital gains taxation is important.

Foremost is the entrepreneur. By taxing his potential capital gains at a higher rate, either the pool of qualified entrepreneurs will decline or investors will have to accept a lower rate of return. In either case, the implications for the U.S. economy are clearly negative. To be successful, the entrepreneur needs capital. Fledgling start-ups depend heavily on equity finance from family, friends, and other informal sources. Professors William Wetzel and John Freear of the University of New Hampshire, in a survey of 284 new companies, found taxable individuals to be the major source of funds for those raising $500,000 or less at a time. The point to be stressed is that individuals providing start-up capital for these new companies pay capital gains taxes and are sensitive to the capital gains tax rate.

Small businesses and entrepreneurs face higher capital costs than Fortune 500 companies. For them, a significant capital gains tax differential can make a big difference.

Q. *Can We "Afford" a Capital Gains Tax Cut?*

A. Yes. Critics of lower capital gains taxes argue that such cuts will reduce federal revenues and thus add to the budget deficit, absorb national saving, and raise interest rates and capital costs. Both economic analysis and experience effectively refute this view.

There is actually little difference between congressional estimates of capital gains tax cuts and those of the Treasury. For example, when President Bush proposed a 30 percent exclusion for capital gains in 1989, the congressional Joint Committee on Taxation (JCT) estimated a "static" loss over 1990-1995 of $100 billion. However, induced realizations—the "unlocking" effect—and depreciation recapture would have recouped almost 90 percent of the loss, according to the JCT, and 110 percent as estimated by the Treasury. [This arithmetic accounts for only one behavioral response—the "unlocking" effect—and the Treasury recoups almost all of the revenue loss. There is no revenue accounting for lower capital costs and increased economic activity. This impact would be substantial.]

Experience indicates that lower capital gains taxes have a positive impact on federal revenues. The most impressive evidence involves the period from 1978 to 1985. During those years the marginal federal tax rate on capital gains was cut from almost 50 percent to 20 percent—but, total individual capital gains tax receipts increased from $9.1 billion to $26.5 billion.

Research by experts at the prestigious National Bureau of Economic Research indicates that the "maximizing" capital gains tax rate—i.e., the rate that would bring in the most Treasury revenue—is somewhere between 9 and 21 percent.

Q. *How Do Our Competitors Treat Capital Gains?*

A. Our international competitors recognize the contribution a capital gains tax differential can make to new risk capital, entrepreneurship, and new job creation.

The United States taxes capital gains more harshly than almost any other industrial nation. A survey of twelve industrialized countries shows that the U.S. capital gains tax rate on long-term gains on portfolio securities exceeds that of all countries except Australia and the United Kingdom, and these two countries index the cost basis of an asset (see Table 1). Germany, Japan, and South Korea exempt or tax only lightly capital gains on portfolio stock.

Not only do virtually all industrialized countries tax individual capital gains at lower rates than the United States; they also accord more favorable treatment to corporate capital gains.

Q. *What Should a Sensible Capital Gains Tax Cut Look Like?*

A. Capital gains tax reform should satisfy three criteria. First, it should make economic sense by lowering the excessively high cost of U.S. capital, reducing the bias against high-risk capital, and ameliorating the taxation of inflationary gains.

Second, it should be fair to all income groups and sectors of the U.S. economy: Main Street and Wall Street, middle-class investors and farmers, new entrepreneurs and retiring businessmen, and individual investors and businesses.

Finally, although there is controversy about the revenue consequences of the capital gains tax reduction, a very strong and credible case can be made that this initiative, with its important macroeconomic consequences, will not reduce total tax revenues and, in fact, is a revenue-raiser.

Q. *Isn't Indexing the Best Way to Lower the Capital Gains Taxes?*

A. Indexing is a very good idea because it adjusts for inflation, but taken alone it is a far from complete solution to the problem. A traditional capital gains tax exclusion is also needed.

Indexing for inflation will not offset much of the negative effects on the cost of capital caused by the very high capital gains taxes resulting from the Tax Reform Act of 1986.

Q. *What Is the Capital Gains Tax Proposal in the GOP "Contract With America?"*

A. The GOP "Contract With America" contains three capital gains incentives:

- *Fifty Percent Capital Gains Deduction*—The "Contract With America" would substantially cut the tax rate on capital gains by allowing taxpayers to exclude one-half of the amount of their net capital gains. Currently, capital gains are taxed at the same rate as ordinary income, subject to a cap of 28 percent. Thus, there is a modest capital gains differential for the upper tax rate brackets, but principally because the 1993 tax law raised income tax rates. The Contract would halve the effective capital gains tax rate for lower- and middle-income taxpayers. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending upon the individual's

Table 1 International Comparison of Capital Gains Taxes and Personal Saving Rates

Country	Capital Gains Maximum Individual Tax Rate[1]		Personal Saving Rate[2]
	Short-term	Long-term	1975-1991
United States	28.0%	31.3%[3]	6.8%
Japan	1% of sale price or 20% of net gain.	1% of sale price or 20% of net gain.	17.3%
Australia	48.3%	48.3%; asset cost is indexed.	9.3%
Belgium	Exempt	Exempt	14.7%
Canada	23.80%	23.80%	12.5%
France	18.1%	18.1%	15.6%
Germany	53.0%	Exempt	12.7%
Hong Kong	Exempt	Exempt	N/A
Italy	25.0%	25.0%	19.8%
Netherlands	Exempt	Exempt	2.9%
Sweden	25.0%	25.0%	1.4%
United Kingdom	40%; asset cost is indexed.	40%; asset cost is indexed.	9.8%

[1] Reflects top marginal rates on portfolio securities gains.
[2] Organization for Economic Cooperation and Development. Net household saving as a percent of disposable income. *OECD Economic Outlook* 52, December 1992, Table R 12, p. 212.
[3] While the top statutory rate is 28.0%, the actual top marginal rate for an individual faced with reduced itemized deductions and phasing out of personal exemptions is 31.3% for a family of four.

Prepared by the American Council for Capital Formation Center for Policy Research.

tax bracket. Corporations would be subject to a top effective capital gains tax rate of 17.5 percent.

- *Capital Gains Indexation*—The "Contract With America" would end the current practice of taxing individuals and corporations on capital gains due to inflation. Currently, taxpayers must pay capital gains taxes on the difference between an asset's sales price and its "basis" (the asset's original purchase price, adjusted for depreciation and other items), even though the increase in value may be due to inflation. The Contract would increase the basis of most capital assets to account for inflation occurring after 1994. Taxpayers would be taxed only on the real—not inflationary—gain.

- *Loss on the Sale of a Home*—The "Contract With America" would treat a loss on the sale of a principal residence as a capital loss. Currently, if a home-owner sells his or her home at a loss, that loss is not deductible (even though gains on future residence sales may be taxable). The Contract would allow taxpayers to deduct the loss on the sale of a principal residence. This loss would be subject to the capital loss limitation rules, which allow a net capital loss (determined after netting capital gains and capital losses) to offset up to $3,000 annually of ordinary income, with the unused portion of the loss carried forward into succeeding years.

Q. What Is a Capital Gain?

A. A capital gain or loss is the difference between the selling price of an asset and its basis (cost). The basis (cost) is the purchase price of the asset, including any brokerage fee. For example, if corporate stock is purchased for $2,000 and later sold for $2,500 (net of broker commissions), the capital gain is the difference between the $2,000 purchase price and the $2,500 received from the sale, or $500. If the asset purchased is a physical asset, such as a building, and the owner had made improvements, then the tax basis is the purchase price plus the cost of the improvements. If the asset depreciates over time, the basis is the original sale price reduced by the decline in value from depreciation.

The distinction between capital assets and other forms of property is the most important concept in the law relating to the taxation of capital gain. Under the Code, any property is a "capital asset" unless it is covered by one of numerous exceptions. The theme running through the exceptions is that capital gains treatment is appropriate only for income resulting from the appreciation in value of investment property or property used in a trade or business. Thus, there are exceptions that deny capital gain treatment for income from personal efforts, income from property not attributable to appreciation (such as interest, dividends, royalties, and rent), and the ordinary profits of business operations.

The primary assets that typically yield capital gains are corporate stock and business and rental real estate, according to a recent report by the Senate Budget Committee. Corporate stock accounts for from 20 percent to 50 percent of total realized gains, depending on the state of the economy and the stock market. There are also gains from assets such as bonds, partnership interests, owner-occupied housing, timber, and collectibles, but all of these are relatively small as a share of total capital gains.

Q. What Is the Current Federal Capital Gains Tax Rate?

A. Gains on the sale of capital assets held for more than a year are limited to a maximum tax rate of 28 percent under the federal individual income tax, even though rates on ordinary income go up to 39.6 percent (or even higher in some cases). Also, gain on the sale of property used in a trade or business is treated as a long-term capital gain if all gains for the year on such property exceed all losses for the year. Qualifying property used in a trade or business generally is depreciable property or real estate that is held more than a year, but not inventory.

Benefits of the 28 percent maximum tax rate are limited to individuals with tax rates above 28 percent—that is, those in the 31 percent bracket, the 36 percent bracket, or the 39.6 percent bracket. For 1994, a taxpayer filing a joint return would have to have taxable income of $91,850 before the 31 percent tax rate applied (single taxpayers would have to have $53,500). Taxable income would have to be $140,000 before the 36 percent rate applied, and $250,000 before the 39.6 percent rate applied.

Under current law, capital gains net of capital losses realized by an individual are taxed at a top

Table 2 History of Capital Gains Tax Rates

Years	Holding Period (%)	Individuals: Top Marginal Rate (%)	Individuals: C-G[a] Rate (%)	Individuals: Diff.[b]	Corporations: Top Marginal Rate (%)	Corporations: C-G[a] Rate (%)	Corporations: Diff.[b] (%)
1942-43	6 mos.	88.0	25.0	63.0	40.0	25.0	15.0
1944-45	6 mos.	94.0	25.0	69.0	40.0	25.0	15.0
1946-50	6 mos.	91.0	25.0	66.0	38.0	25.0	13.0
1951	6 mos	87.2	25.0	62.2	50.8	25.0	25.8
1952-53	6 mos.	88.0	26.0	62.0	52.0	26.0	26.0
1954	6 mos.	87.0	26.0	61.0	52.0	26.0	26.0
1955-63	6 mos.	87.0	25.0	62.0	52.0	25.0	27.0
1964	6 mos.	77.0	25.0	52.0	50.0	25.0	25.0
1965-69	6 mos.	70.0	25.0	45.0	48.0	25.0	23.0
1970	6 mos.	70.0	29.5	40.5	48.0	28.0	20.0
1971	6 mos.	70.0	32.5	37.5	48.0	30.0	18.0
1972-76	6 mos.	70.0	35.0[c]	35.0	48.0	30.0	18.0
1977	9 mos.	70.0	35.0	35.0	48.0	30.0	18.0
1978-10/31/78	1 yr.	70.0	35.0	35.0	48.0	30.0	18.0
11/1/78-6/9/81	1 yr.	70.0	28.0	42.0	46.0	28.0	18.0
6/10/81-6/22/84	1 yr.	50.0	20.0	30.0	46.0	28.0	18.0
6/23/84-86	6 mos.	50.0	20.0	30.0	46.0	28.0	18.0
1987	6 mos.	38.5	28.0	10.5	40.0	34.0	6.0
1988	1 yr.	33.0[d,e]	33.0[d,e]	0	34.0	34.0	0
1990	1 yr.	31.0[f]	28.0[f]	3.0	34.0	34.0	0
1993	1 yr.	39.6	28.0	11.6	35.0	35.0	0
Rep. Contract Proposal[g]	1 yr.	39.6	19.8	19.8	35.0	17.5	17.5

[a] Maximum capital gains tax rate.
[b] Differential between marginal income tax rate and capital gains rate.
[c] Interplay of minimum tax and maximum tax on earned income results in a marginal rate of 49.125%.
[d] Statutory maximum of 28% but "phaseout" notch increases rate to 33%.
[e] Interplay of all "phaseouts" can increase marginal rate to 49.5%.
[f] The Budget Act of 1990 increased the statutory rate to 31.0%, and capped the marginal rate on capital gains at 28.0%. Until 1996, however, some taxpayers will face effective marginal rates of more than 34.0% due to the phase out of personal exemptions and itemized deductions.
[g] The Republican Contract provides: (1) a 50 percent capital gains deduction for individuals and corporations, (2) indexation of the basis of capital assets to eliminate gains due to inflation, and (3) a provision to treat the loss on the sale of a home as a capital loss. The 50 percent capital gains deduction means that capital gains tax rates would be 7.5%, 14.0%, 15.5%, 18.0% and 19.8% for individuals.

Prepared by the American Council for Capital Formation Center for Policy Research.

marginal federal tax rate of 28 percent in taxable income. Net losses are included up to a maximum of $3,000. Net capital losses in excess of $3,000 are carried over to later taxable years. This constraint limits the ability of investors to time the realization of gains and losses so as to minimize taxes.

Corporate capital gains are taxed at a rate of 35 percent, the rate applied to ordinary corporate income.

Q. *What Is the History of Capital Gains Taxes in the United States?*

A. Although the original 1913 Income Tax Act taxed capital gains at ordinary rates, legislation in 1921 provided for an alternative flat-rate tax for individuals of 12.5 percent for gain on property acquired for profit or investment. This treatment was to minimize the influence of the high progressive rates on market transactions. Over the years, many revisions in this treatment have been made. In 1934, a sliding-scale treatment was adopted (where lower rates applied the longer the asset was held). This system was revised in 1938. In 1942, the sliding-scale approach was replaced by a 50 percent exclusion for all but short-term gains (held for less than six months), with an elective alternative tax rate of 25 percent (see Table 2). The alternative tax affected only individuals in tax brackets above 50 percent.

In 1978, a 60 percent exclusion for individuals was introduced and the alternative rate for corporations was lowered to 28 percent. In 1981, the maximum tax rate on capital gains was reduced to 20 percent; the corporate gains tax remained at 28 percent.

The Tax Reform Act of 1986, which lowered overall tax rates and included only two tax rate brackets (15 percent and 28 percent), provided that capital gains would be taxed at the same rate as ordinary income.

In 1990, a 31 percent rate was added to the rate structure for ordinary income. There had, however, been considerable debate over proposals to reduce capital gains taxes. Since the new rate structure would have increased capital gains tax rates for many taxpayers from 28 percent to 31 percent, a separate capital gains rate cap of 28 percent was maintained. The 28 percent cap was continued when the 1993 Omnibus Budget Reconciliation Act added a top rate of 36 percent and a ten percent surcharge on very high incomes, producing a maximum rate of 39.6 percent on ordinary income.

Q. *Do States Also Tax Capital Gains?*

A. Yes. Of the 42 states which tax capital gains, the majority apply this tax to the gain reported on the federal tax return. The Tax Reform Act of 1986, which eliminated the 60 percent exclusion for capital gains income, dramatically increased state capital gains taxes. As noted in a recent op-ed in the *Washington Times*:

> ...State capital gains taxes add another layer of impediment to investment and entrepreneurship, thereby further hampering economic growth and job creation...
>
> Even though a state capital gains tax rate of 4.5 percent, for example, as levied in Connecticut, is less than the national state average of 5.4 percent, it can turn out to be much more daunting after inflation is factored into the equation. For example, if one considers inflation on a venture capital investment of $50,000 made in 1987 and sold for $70,000 in 1993, Connecticut's real capital gains tax rate jumps to 11 percent..
>
> In a state with a much higher capital gains tax rate, such as New York, where the top rate is 7.875 percent, the real rate on such an investment jumps to over 19 percent.

The combined burden of federal and state taxes on capital gains makes it more difficult to raise capital for the start-up and entrepreneurial activity companies which are the source of much economic vibrancy, innovation, and job creation.

Q. *Is Capital Gains a Partisan Issue?*

A. No. A reduction in capital gains taxation has not been a partisan issue in the past and should not be a partisan issue now. Capital gains tax reductions enjoyed bipartisan support from the tax-writing committees in all the major debates on this issue for nearly two decades. The real issues are economic: U.S. productivity growth, competitiveness, and job creation. As to fairness, past capital gains cuts have benefited the public generally by strengthening the U.S. economy. In fact, capital gains tax reductions in the Republican "Contract With America" is one of the most progressive measures to be considered by the Ways and Means Committee in many years. It raises large sums from upper-income taxpayers to fund programs for low income Americans. A number of prominent Democrats have championed lower capital gains taxes over the years. ❖

American Council for Capital Formation
Center for Policy Research

Special Report

January, 1995

Questions and Answers on IRAs

Q. *What is an Individual Retirement Account?*

A. Individual Retirement Accounts (IRAs) were developed in the 1970s to encourage individuals to save for retirement. The 1981 tax act expanded IRAs so that any wage earner could contribute up to $2,000 annually to an IRA; a couple with two wage-earners could contribute $4,000. A couple with a nonworking spouse could contribute $2,250. Contributions were tax deductible and taxes on funds accumulating in an IRA were deferred until the funds were withdrawn. Individuals had to be 59 1/2 to withdraw funds from IRA accounts without penalty.

The Tax Reform Act of 1986 curtailed IRAs so that IRA contributions are not fully deductible except for workers without employer pensions, families with annual incomes under $40,000 and individuals with annual incomes under $25,000. These income limits are not indexed.

Q. *Do IRAs increase saving?*

A. Yes. Prominent public finance economists and scholars, including former Council of Economic Advisers Chairman Martin Feldstein, Harvard Professor Lawrence Summers, now on leave as U.S. Treasury Undersecretary for International Affairs, and Professors David A. Wise of Harvard University, James M. Poterba of Massachusetts Institute of Technology, Steven F. Venti of Dartmouth College, Jonathan Skinner of the University of Virginia, and Richard A. Thaler of Cornell University, have concluded that IRAs—especially tax deductible IRAs—do result in new saving.

Nearly a dozen scholarly studies, using a variety of data sources and employing several different statistical approaches, have examined whether targeted saving vehicles such as IRAs and 401(k)s impact saving. For example, Professor Steven Venti's recent testimony before a Senate Finance Subcommittee examined saving data from a Survey of Income and Program Participation for three different age groups (families reaching age 60 to 64 in 1984, 1987 and 1991).[1] Professor Venti found a striking increase in saving the longer the family has been exposed to the targeted retirement programs—IRAs, 401(k)s, and Keoghs (see Table 1).

The growth in IRA and 401(k) asset balances is astounding, Professor Venti noted. The typical member

Table 1 Financial Assets Saved by Families

	Families reaching age 60-64 in: 1984	1987	1991
Percent of families with targeted retirement saving	38	41	42
Approximate years of exposure to plans	2	5	9
Targeted retirement assets	$7,575	$13,119	$21,613
Total financial assets	$29,847	$34,013	$45,019
Percent of families without targeted retirement saving	62	59	58
Total financial assets	$2,247	$1,982	$1,691

Note: The data on saving are median asset balances in 1991 dollars.

For more information on IRA issues, please contact the American Council for Capital Formation Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006: 202/293-5811.

Table 2 Flow of U.S. Net Saving and Investment (percent of GDP in current $)

	Average 1960-1980	Average 1981-1985	Average 1986-1990	Average 1991-1994[1]
Net private domestic saving	8.1%	7.2%	5.1%	5.2%
State and local government surpluses	0.7%	1.2%	0.9%	0.4%
Subtotal of private and state saving	8.8%	8.4%	5.9%	5.6%
Less: federal budget deficit	-1.0%	-4.1%	-3.2%	-3.6%
Net domestic saving available for private investment	7.8%	4.3%	2.7%	1.9%
Net inflow of foreign saving[2]	-0.4%	1.2%	2.4%	1.1%
Net private domestic investment	7.4%	5.5%	5.1%	3.0%
Personal saving	5.2%	5.6%	3.4%	3.4%
Net business saving[3]	2.9%	1.6%	1.7%	1.8%

[1]The 1994 figures included in this average reflect only the first three quarters.
[2]In the 1960-80 period the United States sent more capital abroad than it received; thus net inflow was negative during this period.
[3]Net business saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.

Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, December 1994.

of the youngest family—those with the nine years of exposure to targeted retirement saving programs—has nearly three times the targeted retirement assets of the oldest cohort. There is a comparable increase in total assets as well. In contrast, among families without IRAs, 401(k)s, and Keoghs, the youngest families have only about 75 percent the financial assets of the older families ($1,691 vs. $2,247). Professor Venti concluded that since total financial assets, including balances in IRAs and 401(k)s, are much larger for the younger cohort in 1991 than for the older cohort in 1984, targeted retirement saving programs did stimulate new saving over the period.

Q. *Why does the United States need more saving?*

A. The U.S. personal saving rate dropped from 5.2 percent of GDP in 1960-1980 to 3.4 percent in 1991-1994 (see Table 2). Saving makes possible the productivity-enhancing investment that is critical to raising real wages for both skilled and unskilled workers. Investment in the United States averaged 7.4 percent of GDP from 1960 to 1980, but since 1991 it has averaged only 3.0 percent, and is unlikely to increase unless U.S. domestic saving increases. The downward trend in U.S. net private domestic investment must be reversed if real incomes are to increase. U.S. family income has been nearly stagnant since the mid-1970s and in recent years family income has actually fallen. For example, real median household income was $39,869 in 1989; income has declined each year to $36,959 in 1993.

In addition, looming in the future is the need to finance the retirement of the "baby boom" generation. Research suggests this generation's saving rate is only one-third the amount needed for secure retirement.

Q. *Who uses IRAs?*

A. Most contributions to IRAs are made by middle-income families, according to Professor Venti. At the IRA program's peak in 1986, about 16 percent of tax filers contributed to an IRA and about 29 percent of all families with a head of household under age 65 had positive IRA assets balances. Of course, households that had low incomes or had a young household head were less likely than wealthier or older households to have an IRA. However, at the peak of the program 75 percent of all IRA contributions were accounted for by families with annual incomes less than $50,000.

IRA participation is also closely related to age. Nearly 50 percent of all families in the 55-65 age interval had an IRA account. Thus even though less than one-third of all families have an IRA at a single point in time, over their lifetimes at least half of all families could be expected to participate in an IRA program.[2]

Q. *Do other countries use IRAs?*

A. Many industrial countries, including Canada, Australia, France, the United Kingdom, the Netherlands, and Belgium, encourage saving through IRA-type programs. Most of these countries permit larger IRA contributions than does the United States, and most allow a tax deduction for the IRA. For example, Canada permits taxpayers covered by an employer's pension plan to contribute $3,500 per year to a Registered Retirement Saving Plan (RRSP); persons without an employer pension plan could contribute up to $13,500 in 1994.

Canada's generous RRSP plan may help explain why that country has a higher personal saving rate than the United States (9.6 percent of disposable income over the 1986-1994 period, compared to 4.7 percent for the United States). Other countries with IRA-type saving programs also have personal saving rates which exceed that of the United States. For example, the personal saving rate was 6.3 percent in Australia, 12.5 percent in France, and 9.1 percent in the United Kingdom over the 1986-1994 period.

Q. *What are the leading proposals for IRA expansion?*

A. IRAs enjoy strong bipartisan support.

- The Republican Contract With America offers a new "American Dream Savings Account" (ADS) which allows a nondeductible annual contribution of up to $4,000 for a married couple ($2,000 for an individual); the annual IRA contribution would be indexed for inflation. If the ADS were held for five years, the taxpayer could withdraw funds without penalty for retirement, first-time home purchases, college, or medical expenses.
- President Clinton has proposed expanding tax-deductible IRAs and permitting the use of the money before retirement to pay for the purchase of a first home, education, catastrophic health costs, or for the care of an elderly parent. The administration proposal raises the current tax-deductible IRA income limit from $40,000 (phasing out at $50,000) to $80,000 (phasing out at $100,000). The administration proposal also allows individuals the option of the "back-loaded IRA" in which after-tax saving is put into an IRA but the proceeds are exempt from tax when withdrawn.
- IRAs have also enjoyed bipartisan support over the years. For example, outgoing Treasury Secretary Lloyd Bentsen is a long-time IRA supporter and cosponsored several bills with Senator Bill Roth (R-DE) to reinstate deductible IRAs while he was chairman of the Senate Finance Committee. Senators Roth and Breaux (D-LA) have introduced similar legislation (S12) in the 104th Congress. Treasury Undersecretary Summers also believes deductible IRAs will help increase the U.S. saving rate.

Q. *Should IRA contribution limits on nonworking spouses be raised?*

A. Yes. Under current law, a family with two wage-earners can contribute up to $4,000 per year to an IRA. In contrast, a couple with one wage-earner can make a total IRA contribution of only $2,250. Over 40 years, the couple in which both spouses work outside the home can contribute $70,000 more to an IRA than can the single-income couple. At a 6 percent return on investment, the first couple would earn almost $300,000 more in savings for its retirement needs than the single-income couple, despite the fact that the retirement needs of both couples would be approximately the same. Changing the current treatment of nonworking spouses who wish to establish IRAs would promote fairness and recognize the retirement needs of the non-wage earning spouse—goals shared by Republicans and Democrats.

Q. *Can we "afford" expanded IRAs?*

A. Yes. As Dr. Summers commented:

> The weight of the available evidence suggests that IRAs generated a significant amount of saving that would otherwise not have taken place. If [deductible] IRAs were reinstated under current law, the government would lose about twenty-five cents for each one dollar of contribution., If more than one-fourth of the money contributed to IRAs represents new saving, IRAs will increase private saving by more than their revenue cost. If this condition is met, the case for reinstating IRAs is clear. Even if it is not, there is still a strong case for saving incentives given that the restoration of IRAs would be likely to come at

the expense of other tax breaks rather than at the expense of larger deficits.[3]

Q. *How do IRAs reinforce the self-control needed for saving?*

A. The importance of self-control is usually ignored in the formulation of a national savings policy. According to Professor Thaler, IRAs help people save by making it more difficult to "get to" the money than if it were left in a bank savings or checking account. Professor Thaler explains that households allocate funds, implicitly or explicitly, into categories, or mental accounts. Some funds, for example those in cash or the checking account, are designated for current consumption. Others, for example those in the savings account, are for "rainy days" or "special occasions." Self-control and mental accounts come together because mental accounts vary in how "tempting" they are to invade. Money in your wallet is more tempting to spend than money in the checking account, which in turn is more tempting than the savings account. Less tempting are funds explicitly set aside for retirement, such as money in an IRA plan. Once this concept is factored in, IRAs can increase saving even if (as some critics charge) all the money put into IRAs would have been saved anyway. By putting funds into a less accessible account, the IRA increases long-term saving.[4]

Q. *Do Americans want to see IRAs expanded?*

A. Yes. Support for additional saving incentives has remained high for several years. Two nationally representative polls, one conducted in December 1990 and one in late-December 1992, demonstrated remarkable stability in the public's opinions concerning saving. According to the poll conducted in 1992 by the Opinion Research Corporation:

- The vast majority of Americans (77 percent) feel it is important for the government to make it a national priority to increase personal saving.
- Nearly nine in ten Americans (88 percent) believe that it is important for them to increase their personal saving rate.
- Seventy-four percent of Americans would save a larger proportion of their income if the government provided them with tax incentives to save more.

In light of this strong support for additional saving incentives, it is not surprising Americans want the 104th Congress to put expanded IRAs at the top of its agenda. According to a post-election survey conducted by the Luntz Research Companies, expanded IRAs are the single most popular tax proposal "on the table."

Q. *Won't Americans just shift money from existing accounts if IRA limits are raised?*

A. No. American families simply do not have the money to keep shifting assets from other accounts into their IRAs, according to a new study by Capital Research Associates.[5] The study classified families by the age of the "family head" and found, specifically, that families headed by individuals 44 years of age and below have median net financial assets of just $700. Even families on the verge of retirement, headed by individuals aged 55 to 64, have median net financial assets of only $6,880. Those families with the highest level of median net financial assets, $10,000, are headed by individuals aged 65 to 74. Overall, the median level of net financial assets for all U.S. families amounts to approximately $1,000, the analysis concluded, thus suggesting that American families cannot simply shift assets from other accounts to IRAs. ❖

Notes

1. Steven F. Venti, "Promoting Saving for Retirement Security," testimony presented to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994.

2. Venti, "Promoting Saving for Retirement Security."

3. Lawrence H. Summers, "Stimulating Personal Saving" in *The U.S. Savings Challenge: Policy Options for Productivity and Growth*, ed. by Charls E. Walker, Mark A. Bloomfield, and Margo Thorning (Boulder, Colo.: Westview Press, 1990) p. 170.

4. Richard H. Thaler, "Self-Control, Psychology and Savings Policies," testimony presented to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994.

5. Joseph M. Anderson, "The Wealth of U.S. Families in 1991 and 1993," (Chevy Chase, Md.: Capital Research Associates, December 1994). The study was commissioned by Merrill Lynch and Co.

AMERICAN COUNCIL FOR CAPITAL FORMATION
CENTER FOR POLICY RESEARCH

SPECIAL REPORT

November, 1994

The Impact of the Alternative Minimum Tax on Investment and Economic Growth

by Margo Thorning*

Q. *What is the Corporate Alternative Minimum Tax?*

A. The Tax Reform Act of 1986 created a comprehensive alternative minimum tax (AMT) system that exists separate from, but parallel to, the regular tax system. Under the AMT scheme, taxable income is modified by an intricate series of "adjustments" and by "preference items" to arrive at alternative minimum taxable income. Depreciation allowances for firms paying the alternative minimum tax are generally much less favorable than those for firms paying the regular corporate income tax. The corporate minimum tax rate is 20 percent, while the top minimum tax rate for individuals is 28 percent.

There are three main reasons why corporations can become AMT payers: (1) a high level of investment in assets such as equipment and structures, and/or (2) low taxable income due to cyclical downturns, strong international competition, or other factors, and/or (3) low real interest rates.

Q. *How Does the AMT Affect Investment Spending?*

A. A study by Prakken, Varvares, and Meyer (PVM) argues that the AMT has the potential to reduce investment spending in one of two ways.[1] First, AMT-filers pay a higher average tax rate and consequently generate less internal cash flow than they would under the regular tax. This, in turn, may curb investment by firms with impeded access to capital markets. Second, the AMT affects the marginal tax rate on capital, and hence may discourage investment by raising what in neoclassical investment theory is known as the rental price of capital (or the "cost of capital"). The "rental price" is defined as the annual cost (interest plus depreciation) per unit of capital, after adjusting for the real purchase price of capital and allowing for corporate taxes, including deductions for depreciation and interest.

PVM's results show that firms permanently on the AMT face capital costs significantly higher than firms that pay the regular corporate income tax. PVM's econometric simulations show that if all firms were to face the AMT indefinitely (the worst case scenario), the result would be to reduce the level of output by approximately $60 billion annually relative to the case in which all firms paid the regular income tax. Ultimately, the equipment/output ratio would fall by 3 percent. In absolute terms, the stock of equipment would be 3.9 percent lower.

Q. *How Does the AMT Affect U.S. Cost Recovery Compared to Our Competitors?*

A. Research by Arthur Andersen and Co. shows that U.S. firms paying the AMT recover their investment costs for new equipment much more slowly than do companies in major competitor nations. For example, the present value of cost recovery allowances for U.S. steel firms using continuous casting equipment is only 57.7 percent compared to 79.3 percent in Germany and 88.3 percent in Brazil (see Table 1).

[1] Joel L. Prakken, Chris P. Varvares and Laurence H. Meyer, "Investment, Economic Growth and the Corporate Alternative Minimum Tax," *Tax Policy for Economic Growth in the 1990s*, American Council for Capital Formation Center for Policy Research, 1993.

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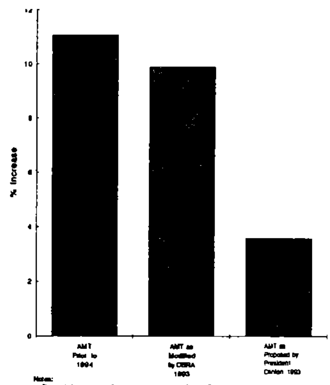
Q. *How Does the AMT Affect Taxes for Firms that Purchase Pollution-Control Equipment?*

A. Capital cost recovery provisions for pollution-control equipment are much less favorable now than prior to TRA's passage. For example, the present value of cost recovery allowances for wastewater treatment facilities used in pulp and paper production was 98.0 percent prior to TRA. Under regular TRA income tax, the present value dropped to 78.5 percent, while for AMT payers, the figure is 62.1 percent. Scrubbers used in the production of electricity fared even worse. Prior to TRA, the present value was 86.8 percent. Today, the present value is only 50.8 percent; for AMT taxpayers the figure drops to 41.5 percent. As is true in the case of productive equipment, loss of the investment tax credit and lengthening of depreciable lives both raise effective tax rates.

Q. *Didn't the Changes to the AMT in the 1993 Budget Act "Fix" the Problems Faced by Capital Intensive Firms?*

A. While the repeal of the adjusted current earnings (ACE) adjustment to depreciation contained in OBRA 1993 was a positive step, the capital cost disadvantage faced by firms on the AMT remains (see Figure 1). AMT firms with assets depreciated over seven years face capital costs 10 percent higher than for firms on the regular corporate income tax. Had the reform proposed by the Clinton administration been enacted, AMT firms' capital cost disadvantage would have fallen to less than 4 percent. ❖

Figure 1 Increase in Cost of Capital for Equipment Incurred by AMT Firms Compared to Firms Paying the Regular Income Tax under Prior Law, OBRA 1993 Changes and President Clinton's Original 1993 Reform Proposal



Notes:
Depreciation systems for an asset depreciated over 7 years under regular law.
AMT prior to 1994: 120% declining balance recovered over 13 year period.
Clinton's AMT: 120% declining balance recovered over 7 year period.
OBRA 1993: 150% declining balance recovered over 13 year period.

Explanation:
A firm on the current AMT faces a cost of capital 9.87 percent higher than a firm paying the regular income tax; the Clinton/House AMT proposal would have reduced the capital cost disadvantage to 3.8 percent for an AMT firm.

The analysis assumes that firms are permanently on the AMT. The capital cost calculations use the pretax return required by an investor and are net of economic depreciation.

Source: Capital cost calculations by Laurence H. Meyer & Associates, chart prepared by ACCF Center for Policy Research, December 1993.

Table 1 International Comparison of the Present Value of Equipment Used to Make Selected Manufacturing Products and Pollution-Control Equipment (as a percent of cost)

	Computer Chips	Telephone Switching Equipment	Factory Robots	Crank-shafts	Continuous Casting for Steel Production	Engine Blocks	Wastewater Treatment for Chemical Production	Wastewater Treatment for Pulp and Paper Equipment	Scrubbers Used in Electricity Plants
United States									
1985 Law	98.0	98.0	98.0	98.0	98.0	98.0	98.0	98.0	86.8
MACRS	83.4	83.4	78.5	78.5	78.5	78.5	83.4	78.5	50.8
AMT	80.8	78.1	68.3	64.1	57.7	60.3	69.4	62.1	41.5
Brazil	75.7	74.8	74.7	74.7	88.3	74.7	74.7	74.7	79.4
Canada	73.4	72.2	70.3	70.1	70.5	69.9	82.8	82.8	82.8
Germany	80.7	80.1	79.8	81.1	79.3	81.1	67.6	65.5	64.6
Japan	78.8	77.5	73.5	74.4	70.9	74.1	75.2	74.2	72.9
Korea(w/ 3% ITC)	86.2	81.3	79.6	76.9	74.4	76.5	94.2	93.1	91.8
Singapore	90.1	90.1	90.1	90.1	90.1	90.1	90.0	90.0	90.0
Taiwan	80.6	73.7	75.1	58.4	57.7	57.9	144.1	144.1	144.1

Source: Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad is Bad." *Economic Effects of the Corporate Alternative Minimum Tax*, published by the American Council for Capital Formation Center for Policy Research (Washington, D.C.: September 1991); and unpublished data incorporating the AMT provisions of OBRA 1993.

Chairman ARCHER. Thank you.

Our next witness is Dr. Allen Sinai, managing director and chief global economist, Lehman Brothers, Boston, Mass. We are pleased to have you with us.

STATEMENT OF ALLEN SINAI, PH.D., MANAGING DIRECTOR AND CHIEF GLOBAL ECONOMIST, LEHMAN BROTHERS, BOSTON, MASS.

Mr. SINAI. Thank you. I am pleased to be here. After 4 years of an economic upturn and now a near full employment economy, extending and preserving the business expansion without rising inflation is a major challenge for economic policy. So what economic policies might increase saving, stimulate productive investment, raise productivity growth, and increase the potential supply of the economy should take center stage.

It is in this context that the American dream savings account, other provisions in the American Dream Restoration Act and of the tax reductions in the Job Creation and Wage Enhancement Act of the Contract With America are examined. All more or less as objectives increased savings, higher investment, greater capital formation, more entrepreneurship, and improved family welfare.

On this basis, some tax changes, for example, the $500-per-child tax credit under 18 for families with incomes up to $200,000 and other refundable tax credits for child adoption and family care of dependent senior citizens do not score well. These are principally consumption stimuli as opposed to savings stimuli.

Some of the tax proposals in the Contract do well on the criteria of savings, investment, productivity growth, entrepreneurship, and increased potential output, but none would be beneficial under full employment if the Federal budget deficit were to rise significantly.

Of the tax reductions considered, those with greatest potential economic effects on savings and investment I believe are capital gains tax reduction, neutral cost recovery, and the ADS account. Preliminary results from some quantitative work that we have done on proposed capital gains tax reductions are provided in the testimony.

I want to focus on some of the conclusions. First, many of the tax reductions in the Contract With America are very positive for saving, investment, productivity and entrepreneurship, but in most cases the macroeconomic impact is relatively small, perhaps only marginal. That is true for the increased small business deductions, property expenses, increased estate and gift tax exemptions, and the greater deductibility of expenses for home offices.

They all have a positive saving and entrepreneurship effect, but too small to make much of a difference in the overall economy. With funding for the total of all the tax reductions perhaps difficult on economic and political grounds, it would be wise to choose among them, skinnying down the costs and reducing the funding requirements.

Also, given that the economy is near full employment, I would suggest that only those tax reductions that increase potential supply should be used. And those prime candidates are the capital gains tax reductions, neutral cost recovery, and the ADS.

Some of the quantitative results we find from capital gains tax reductions and simulating it with our large-scale model of the U.S. economy include the following. The capital gains tax reductions, as proposed, do stimulate economic growth, do raise economic activity compared to what otherwise would occur, do create extra jobs, 1.4 million jobs over the 5-year period of the program, and they do raise national saving at least initially. If these capital gains tax reductions were financed by reductions in government spending, then national savings would be permanently raised by this combination, that is, reduced capital gains and reduced government spending.

Taking account of feedback effects on the economy from the tax reductions of the stimulative effect and increased capital gains realizations—here I don't mean unlocking; just realizations from a better economy and a better stock market—the revenue losses for the capital gains tax reduction net is estimated at $62 billion over 5 years.

If one adds the unlocking of unrealized capital gains to that, and unlocking is now well accepted as a real phenomenon by the academics who study it, and by those of us who work in the business world, the capital gains tax reductions are the only tax proposal of all that has a shot at paying for itself over the horizon in which they are applied.

Now, the neutral cost recovery accelerated depreciation also could be beneficial for stimulating investment, capital formation, and productivity, but it would not have the broad-based effects and potential for revenue feedback of the capital gains tax reductions. It would be less cost effective ex-post than reducing capital gains taxes.

The ADS account or enhanced IRAs very likely would be quite popular, with many new accounts created in financial institutions for them, but the net effect on overall savings is questionable, with mixed results from studies on this topic. I think, though, the particular form of the proposal this time, the ability to draw tax free for certain purposes could provide a stronger incentive to current saving and the savings rate than past types of IRAs and so it should be considered.

In an economy so near full employment, it is important to raise productivity, savings, investment, and potential supply through increased savings and investment of all the measures for reducing taxes in the Contract With America. Capital gains tax reduction has the lead on this score.

Thank you.

[The prepared statement and attachments follow:]

Saving and Investment in a Full Employment Economy:
The *Contract With America* Tax Reductions
by Allen Sinai*

Introduction and Summary

After four years of an economic upturn and now a near full employment economy, extending and preserving the business expansion without accelerating inflation has become the major challenge for economic policy.

In almost all cyclical episodes, once the economy reaches full employment, booming spending and heavy borrowing, spiraling inflation, speculative excesses in the financial and real economy, and upward spiraling interest rates eventually lead to financial instability, credit crunches, declines in real economic activity and a full-fledged recession.

What economic policies might lower consumption and increase saving, stimulate productive investment, raise productivity growth, increase the potential output, or aggregate supply, of the economy take center stage in a full employment economy, since a side effect from strong and rapid growth in such a situation can be accelerating and unwanted inflation.

Economic policies that previously might have been appropriate no longer are so at or near full employment. Instead, monetary and fiscal policies must be designed to slow the demand-side of the economy and raise the supply-side so as to balance the growth of aggregate demand and aggregate supply.

Against a given backdrop of monetary policy, tax and spending policies that shift consumption to saving, induce productive investment and capital formation, raise productivity growth, and provide incentives for entrepreneurship are to be preferred.

It is in this context that the American Dream Savings Account (ADS Account), other provisions in the American Dream Restoration Act, and some of the tax reductions in the Job Creation and Wage Enhancement Act of the *Contract With America* are examined.

All, more or less, have as objectives increased savings, higher investment, greater capital formation, more entrepreneurship, and improved family welfare. Presumably, if any of these goals were achieved, productivity could improve and also the potential output, or supply, of the economy. Also, the revenue loss, or cost for each proposal must be assessed, since under the Omnibus Budget Reconciliation Acts of 1990 and 1993 and Budget Enforcement Act of 1990, tax reductions have to be paid for by spending reductions, other outlay cuts, or higher taxes elsewhere.

On this basis, some tax changes not considered here, for example, the $500 tax credit per child under 18 for families with incomes up to $200,000, the $5,000 refundable tax credit for child adoption, and $500 credit for family care of dependent senior citizens do not score well. The same applies to the Administration's scaled-down proposal for a child tax credit of $500 in families with incomes of $75,000 and under. These tax reductions would tend to stimulate consumption more than savings or potential supply, and because of large revenue losses would require substantial and possibly politically difficult reductions in federal government spending and outlays. *In a full employment economy, any sizeable net fiscal stimulus or deficit-financed reductions of taxes should be avoided.*

Some of the tax proposals in the *Contract With America* do well on criteria of savings, investment, productivity growth, entrepreneurship and increased potential output. *None* would be beneficial in a fully employed economy *if* the federal budget deficit were to rise significantly. Sizeable deficit-financed tax reductions of any kind are the wrong action to take at full employment, inviting the very result economic policy must try to avoid—potentially higher inflation, speculative excesses in spending, borrowing and financial investments, a weaker dollar, tighter monetary policy, spiraling interest rates, and eventually an economic downturn.

Of the tax reductions considered in the American Dream Restoration Act and Job Creation and Wage Enhancement Act, those with the greatest potential economic effects on saving and investment are capital gains tax reductions, neutral cost recovery, and the ADS Account.

Preliminary results from macroeconometric model analysis of the proposed capital gains tax reductions are provided, since this policy change probably would have the greatest macroeconomic impact. The effects on the economy, inflation, cost of capital, savings, capital spending, employment, productivity, potential output, the federal budget deficit, and federal government tax receipts, on ex-ante (static) and ex-post (dynamic) bases, are considered (Appendix Tables 3-5).

Here, dynamic refers to capital gains realizations and full macroeconomic feedback effects of the capital gains tax reductions. Estimates of increased capital gains realizations that occur because of the lower capital gains tax, a better stock market, and increased saving are superimposed on the model-based macroeconomic results to assess more fully the dynamic, or ex-post, revenue losses. Estimates of a "taxpayer effect" or "unlocking"—the realization of previously unrealized capital gains and payment of additional taxes because of the new capital gains tax reductions—are taken from Joint Tax Committee (JTC) and Office of Tax Assessment (OTA) figures used in the evaluation of capital gains tax reduction proposals made by the Bush Administration. The capital gains tax proposals this time are greater in scope, a larger reduction in the effective capital gains tax rate and through the addition of indexing for inflation.

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* Chief Global Economist and Director, Lehman Brothers Global Economics.

The results are presented without and with equivalent reductions in spending and/or transfers to offset the ex-post or dynamic loss of revenues from the tax reductions. Monetary policy is not changed from a baseline situation.

The Baseline Forecast (January 1995) parameters that underlie the model simulation are shown in Table 1 of the Appendix, essentially a near-balanced growth path for the economy that reflects economic forces in place now to slow the demand-side of the economy in-line with potential supply. This Baseline scenario shows a reduction of inflation pressure as the economy slows, permitting tax reductions to occur with less chance of an inflationary effect.

Some conclusions, briefly:

- Many of the tax reductions in the *Contract With America* (Table 2, Appendix) are very positive for saving, investment, productivity, entrepreneurship and potential output. But, in most cases the macroeconomic impact would be relatively small, and perhaps only marginal. This is true for increased small business tax deductions for property expenses, increased estate and gift tax exemptions then indexed for inflation, and the greater deductibility of expenses for home offices. All have a saving or entrepreneurship effect, but too small to make much of a difference in the overall economy.

  The Modify Marriage Penalty provision, at a $10 billion cost, would be designed to correct a socially undesirable subsidy. Raising social securities earnings limits to $30,000, phasing out the social security tax increase recently passed into law, and tax incentives for private long-term care insurance are more consumption-oriented than for savings and investment.

- If all provisions were enacted, the tax reductions could be very costly, some $193.3 billion over five years, according to House of Representative estimates, adding sizably to the federal budget deficit unless offset by spending or outlay reductions. With reductions in defense outlays (other than already programmed in prior legislation), social security, net interest and much of Medicare and Medicaid "off the table," savings to finance all the tax cuts could be hard to find or politically difficult. A balanced budget amendment could not be passed quickly enough to fund the aggregate of tax reductions, many of which are designed to be implemented on January 1, 1995 or in January 1996.

- With funding for all the tax reductions difficult on economic and political grounds, it would be wise to chose among them, skinnying-down costs and reducing the funding requirements. Also, given that the economy is near full employment, only those tax reductions that increase potential supply should be used.

- The prime candidates are thus capital gains tax reductions, neutral cost recovery, or the new ADS Account, an essentially enhanced IRA.

- The capital gains tax reductions were simulated in the Sinai-Boston large-scale macroeconometric model of the U.S. economy, a 50% exclusion for gains on assets held at least one year and indexing for inflation over the holding period of the asset.

  These proposals would have the greatest macroeconomic effects of the various savings-investment oriented tax reductions, stimulating economic activity, increasing jobs, increasing capital spending and capital formation, for a time improving national savings, increasing entrepreneurship, and raising the potential output of the economy without generating higher inflation (Table 3, Appendix).

  - According to the Sinai-Boston Model, over the five-year period from 1995 to 1999, real GDP would be $26.3 billion higher per year and real economic growth up 0.1 percentage point per annum compared with a situation of no capital gains tax reductions. A considerable increase in business capital spending is estimated, 2.1% a year relative to the Baseline, with about two-thirds of the additional spending in equipment. 283,000 jobs a year or about 1.4 million over the five-year period would be gained. Productivity growth would be up 0.1 percentage points a year and potential output by $4.4 billion per year.

  - National savings would not change much, principally because of a net, after feedback, rise in the federal budget deficit of $12.3 billion per annum. But, business savings would move sharply higher, by $10.2 billion per year (Table 4).

  - The stronger economy stems from a lower cost of capital with the reductions in capital gains taxes, increased business and personal saving, higher business spending on plant and equipment, the increased stock prices and higher household net worth as investors shift funds away from other investments into stocks, increased hiring and new jobs, and wealth, income, and profits effects on spending, saving, and purchases of financial assets. Short-term interest rates would move somewhat higher assuming no change in monetary policy. But, long-term interest rates likely would drop somewhat from positive wealth and income effects.

  - With the increased capital formation, entrepreneurship measured by new business incorporations and reductions in government operations, productivity would increase and so would the potential output of the economy. This supply-side effect, although very modest, would tend to limit any inflationary effect of the tax reductions. The balanced nature of the economy before the tax reductions in terms of demand and supply are part of the lack of any inflationary effect. The unemployment rate would move down by 0.1 percentage point per year.

- Taking account of the feedback effects from the tax reductions, increased capital gains realizations and stronger economy, ex-post, or dynamic estimates of revenue losses total $61.9 billion, or $12 billion per year (Table 5).

  Assuming that some "unlocking" occurs, an effect that is almost universally agreed upon, the net cost of the capital gains tax cuts is even less, with a possibility that the effects would go a long way toward fully paying for the initial loss of ex-ante tax receipts. Unlocking estimates can very considerably, however, so that a precise estimate of the net cost in reduced tax receipts cannot be made at this point.

- Financing the capital gains tax reductions with reduced government spending and/or outlays weakens the macroeconomic effects, but does not wipe them out (Table 6). Growth, jobs, investment, entrepreneurship and employment all rise, as does consumption. National saving increases substantially, however, because of the reductions in spending/outlays (Table 7). The combination, capital gains tax reductions and cutbacks in government spending and outlays to match the ex-post revenue losses, about $62 billion over five years, produces an economy that, on balance, grows faster, creates more jobs, generates more capital formation and raises productivity without any pickup on inflation. Increased savings and investment tilt the economy away from consumption.

- Neutral cost recovery, or accelerated depreciation, also could be beneficial for stimulating investment, capital formation and productivity, but without the broad-based effects and potential for induced revenue feedback of the capital gains tax reductions. It would be less cost effective, ex post, than reducing capital gains taxes.

- The ADS Account, or enhanced IRA, very likely would be quite popular, with many new accounts created in financial institutions for them. But, the net effect on overall saving is questionable, with mixed results from studies on this topic.

  Most likely, a considerable switching of savings from other vehicles to the ADS Accounts would occur, a plus for financial institutions but not necessarily reducing consumption and raising saving relative to disposable income. The ability to draw, tax-free, on the ADS Account for purposes of education, medical costs, insurance for long-term care, and retirement could provide a powerful incentive to current saving, however, with this proposal having a better chance of increasing the personal savings rate than previous types of IRAs.

In summary, the tax reductions proposed in the *Contract With America* have much to be commended, with many aimed at and contributing to increased savings, investment, productivity, entrepreneurship, and higher potential output. These are all good supply-side dimensions, whose beneficial effects would be buttressed if financed by reductions in the operation of the federal government, headcount reduction, consolidation, outsourcing, privatization of certain functions and reductions in entitlements. Consumption spending also would be increased, relatively more under some measures than others. Family tax credits do not score well on supply-side considerations and are principally a stimulus to consumption.

Of all the tax reductions considered, the most beneficial, in a balanced way, to both the demand-side and supply-sides of the economy at potentially least net cost, is the 50% exclusion of capital gains from taxation, effectively having the capital gains tax rate at all personal and corporate income tax levels, and the indexing of capital gains to inflation.

Econometric model simulations with the Sinai-Boston Model of the U.S. Economy also show significantly positive effects on economic activity, real economic growth, capital spending for equipment and plant, jobs, and national saving if the capital gains tax reductions are financed by equivalent cuts in spending and/or outlays.

The tax on inflation-generated capital gains has long been considered a distortion that would be corrected on indexing. The stimulation to the supply- and demand-sides of the economy through an effective halving of capital gains tax rates is tolerable for an economy near full employment, given the savings-investment dimensions of the capital gains tax reductions.

On several criteria for judging changes in taxes—allocative efficiency, economic growth, savings and investment, international competition and fairness—capital gains tax reduction wins on almost all. The one exception is equity, because higher income families tend to hold more of the assets that could be subject to capital gains.

In an economy so near full employment, it is important to raise productivity and potential supply through increased saving and investment. Of all the measures for reducing taxes in the *Contract With America*, capital gains tax reductions lead on this score.

Appendix
Charts and Tables

Chart 1
The "Output Gap"
(Bils. 87 $s)

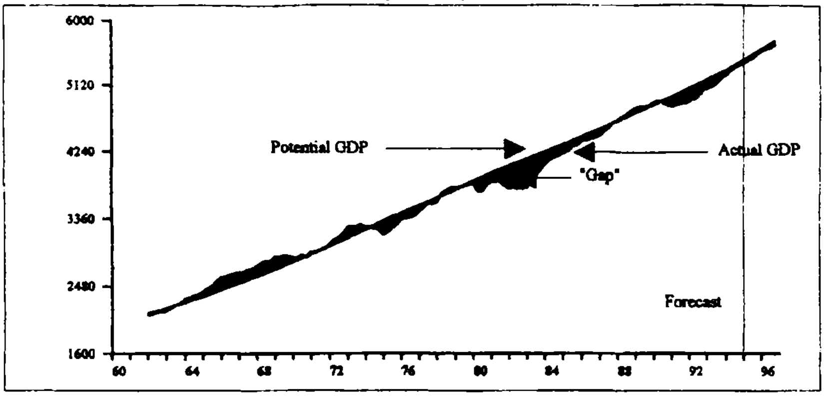

Chart 2
Manufacturing Capacity Utilization (Percent)

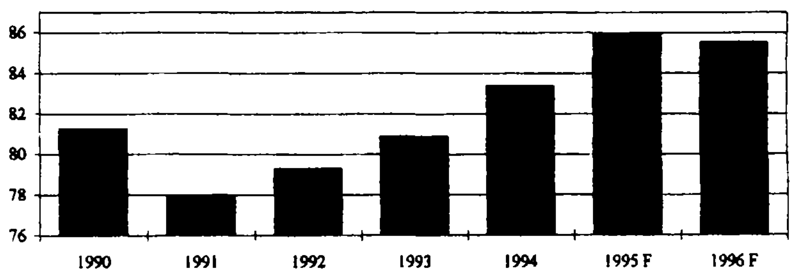

Chart 3
Unemployment Rate
(Percent)

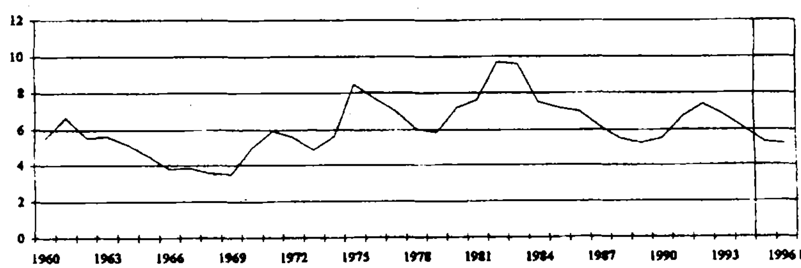

Table 1
Baseline Forecast Parameters*
Economic Assumptions (Calendar Years, Except Where Noted)

	1993	1994	1995	1996	1997	1998	1999
Real GDP (% chg., 4th qtr./4th qtr.)	3.1	4.0	2.7	2.5	2.0	2.8	2.1
GDP Deflator (% chg., 4th qtr./4th qtr.)	1.8	2.6	3.4	2.9	3.2	2.6	2.5
Unemployment Rate (%)	6.8	6.1	5.3	5.2	5.6	5.5	5.7
91-Day Treasury Bill Rate	3.0	4.3	6.3	5.9	4.6	4.9	4.5
10-Year Treasury Note Rate (%)	5.9	7.1	7.7	7.2	7.0	7.5	6.9

Source: Lehman Brothers Global Economics (LBGE).
*January forecast, LBGE.

Table 2
Tax Reductions in the *Contract With America**
(Bils. of $'s)

Acts and Provisions	5-Year Cost or Savings (-)
Reinforcing Families	
Tax Incentives for Adoption	0.9
Dependent Care Tax Credit for Seniors	8.0
American Family Tax Relief in American Dream Restoration Act	
$500 Per Child Tax Credit	107.0
Modify Marriage Penalty	10.0
American Dream Savings Account (Super IRA or ADS Account)	-4.7
Senior Citizens' Reforms	
Raise Social Security Earnings Limit to $30K	6.8
Phase-Out Clinton Social Security Tax Increase	17.0
Tax Incentives for Private Long-Term Care Insurance	1.3
Economic Growth/Regulatory Reform (Job Creation and Wage Enhancement Act)	
Cut Capital Gains Rate (50% Exclusion/Index for Inflation)	56.0
Neutral Cost Recovery	-19.5
Small Business Expensing	3.5
Raise the Estate and Gift Tax Exclusion	6.5
Restore Tax Deductions for Home Offices	0.5
Total	193.3

*House Budget Committee, Republican Staff Estimates, October 1994.

Table 3
Macroeconomic Effects of a Capital Gains Tax Cut*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
Real GDP - Level						
(Bils. 87 $'s)	5.3	21.5	29.1	34.0	41.4	26.3
(Pct. Chg.)	0.1	0.4	0.5	0.6	0.7	0.5
Real GDP-Growth (Pctg. Pts.)	0.1	0.3	0.1	0.1	0.1	0.1
Business Capital Spending						
Total (Bils. 87 $'s)	2.2	11.5	18.8	23.3	27.9	16.7
(Pct. Chg.)	0.3	1.5	2.4	2.8	3.2	2.1
Plt. (Bils. 87 $'s)	1.0	5.2	7.6	8.4	9.3	6.3
(Pct. Chg.)	0.6	3.2	4.4	4.7	5.0	3.6
Equip. (Bils. 87 $'s)	1.2	6.3	11.2	14.8	18.6	10.4
(Pct. Chg.)	0.2	1.1	1.8	2.3	2.7	1.6
Capital Formation - Stocks						
Plt. (Bils. 87 $'s)	0.3	3.8	10.4	17.9	25.7	11.6
(Pct. Chg.)	0.0	0.1	0.4	0.7	0.9	0.4
Equip. (Bils. 87 $'s)	0.4	4.5	12.9	23.8	36.7	15.7
(Pct. Chg.)	0.0	0.2	0.4	0.8	1.1	0.5
Consumption						
(Bils. 87 $'s)	3.9	17.0	26.2	30.4	33.9	22.3
(Pct. Chg.)	0.1	0.5	0.7	0.8	0.8	0.6
Real Net Exports						
(Bils. 87 $'s)	-1.5	-10.3	-19.4	-22.9	-23.4	-15.5
Inflation - GDP Deflator						
(Pctg. Pts.)	-0.0	-0.0	0.1	0.0	-0.0	0.0
Employment and Unemployment						
Payroll (Mils.)	-0.028	0.251	0.428	0.404	0.361	0.283
Unemp. Rate (%)	-0.0	-0.1	-0.2	-0.2	-0.2	-0.1
Productivity Growth (Pctg. Pts.)	0.1	0.1	0.1	0.2	0.2	0.1
Potential GDP						
(Bils. 87 $'s)	0.2	1.5	4.0	6.8	9.7	4.4
(Pct. Chg.)	0.0	0.0	0.1	0.1	0.2	0.1
Interest Rates (%)						
90-day T-Bill	0.02	0.09	0.14	0.16	0.18	0.12
30-year Treas.	-0.11	-0.11	-0.08	-0.08	-0.09	-0.10
AAA-Equiv. Corp. New Issue	-0.12	-0.16	-0.12	-0.11	-0.13	-0.13
Aftertax Return on Equity	0.96	1.31	1.35	1.41	1.47	1.30
Cost of Capital (%)						
Pretax Equity	-0.74	-1.03	-1.08	-1.15	-1.22	-1.04
(Pct. Chg.)	-5.1	-7.2	-7.6	-7.9	-8.3	-7.2
Aftertax Wted. Avg. Cost - Debt & Equity	-0.27	-0.36	-0.39	-0.42	-0.46	-0.4
(Pct. Chg.)	-2.7	-3.7	-3.9	-4.1	-4.3	-3.7
S&P500						
(Pct. Chg.)	0.3	1.0	1.2	1.4	1.7	1.1
Exch. Rate						
(Pct. Chg.)	0.0	0.2	0.5	0.1	-0.2	0.1
Household Net Worth						
(Bils. $'s)	24.5	104.0	187.6	262.9	334.8	182.7
(Pct. Chg.)	0.1	0.4	0.7	0.9	1.1	0.7
Fed. Bdgt. Def. (NIPA)						
(Bils. $'s)	-11.8	-11.5	-10.5	-12.7	-15.0	-12.3
Personal Savings						
(Bils. $'s)	5.8	6.4	1.9	-3.7	-6.6	0.8
Business Savings						
(Bils. $'s)	6.6	10.4	10.8	11.1	12.1	10.2
National Savings						
(Bils. $'s)	0.8	6.1	3.0	-4.7	-8.9	-0.7
National Savings Plus Earnings from Higher Realizations (Bils. $'s)	--	--	--	--	--	--

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.

Table 4
National Savings*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
National Saving	0.8	6.1	3.0	-4.7	-8.9	-0.7
Personal Saving	5.8	6.4	1.9	-3.7	-6.6	0.8
Business Saving	6.6	10.4	10.8	11.1	12.1	10.2
Government Surplus or Deficit (-) (NIPA)	-11.6	-10.6	-9.7	-12.1	-14.5	-11.7
Federal	-11.8	-11.5	-10.5	-12.7	-15.0	-12.3
State and Local	0.3	0.9	0.8	0.6	0.5	0.6

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.

Table 5
Federal Tax Receipts*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Cum. 1995-99
Total Receipts	-12.1	-12.5	-11.1	-12.4	-13.8	-61.9
Personal	-7.6	-9.0	-8.8	-9.9	-11.4	-46.6
Ordinary	0.3	2.1	3.4	3.7	4.2	13.7
Capital Gains	-7.8	-11.1	-12.1	-13.6	-15.6	-60.3
Corporate	-4.5	-5.3	-5.3	-5.7	-5.8	-26.6
Ordinary	0.7	2.0	2.4	2.7	3.4	11.1
Capital Gains	-5.1	-7.2	-7.7	-8.4	-9.2	-37.7
Excise	0.0	0.2	0.3	0.4	0.4	1.4
Social Insurance	-0.1	1.5	2.7	2.8	2.9	9.9
Ex-Ante (Static) Revenue Loss	-25.1	-36.3	-39.8	-43.8	-48.8	-193.8
Personal**	-14.8	-22.1	-24.8	-27.6	-30.9	-120.2
Corporate**	-10.3	-14.2	-15.0	-16.2	-17.8	-73.5
Exclusion**	-24.8	-34.8	-37.0	-39.4	-42.4	-178.4
Indexing**	-0.3	-1.5	-2.8	-4.4	-6.4	-15.4
Taxpayer Effect (Increased Realizations, LBGE)	10.2	15.7	16.6	17.6	19.1	79.2
Economic Feedback Effect (Increased Tax Receipts from Macroeconomic Feedback - LBGE)	2.9	8.1	12.1	13.8	15.9	52.8
Ex-Post (Dynamic) Revenue Loss						
With Increased Realizations (LBGE)	-12.1	-12.5	-11.1	-12.4	-13.8	-61.9
With "Unlocking" Estimates						
Personal						
JCT (1)	-9.1	6.4	3.3	2.5	-0.4	2.7
OTA (1)	-9.3	6.8	7.3	4.6	2.8	12.2
Pers. and Corp. (Corp. Est., LBGE)						
JCT (1)	-7.2	9.2	4.8	4.2	-2.1	8.9
OTA (1)	-7.4	9.6	8.8	6.3	1.1	18.4

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** LBGE Estimate.
(1) JCT - Joint Committee on Taxation, 1990 estimate of Bush Administration capital gains proposal, no indexing.
OTA - Office of Tax Analysis, 1990 estimate of Bush Administration capital gains proposal, no indexing.

Table 6
Macroeconomic Effects of a Capital Gains Tax Cut*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
Real GDP - Level						
(Bils. 87 $'s)	-4.8	12.5	23.6	27.5	36.8	19.1
(Pct. Chg.)	-0.1	0.2	0.4	0.5	0.6	0.3
Real GDP-Growth (Pctg. Pts.)	-0.1	0.3	0.2	0.1	0.1	0.1
Business Capital Spending						
Total (Bils. 87 $'s)	0.8	9.8	17.7	22.6	27.8	15.7
(Pct. Chg.)	0.1	1.3	2.3	2.8	3.2	1.9
Plt. (Bils. 87 $'s)	0.7	4.8	7.5	8.5	9.5	6.2
(Pct. Chg.)	0.4	2.9	4.4	4.8	5.1	3.5
Equip. (Bils. 87 $'s)	0.1	5.0	10.2	14.1	18.3	9.5
(Pct. Chg.)	0.0	0.9	1.7	2.2	2.7	1.5
Capital Formation - Stocks						
Plt. (Bils. 87 $'s)	0.2	3.3	9.6	17.2	25.2	11.1
(Pct. Chg.)	0.0	0.1	0.4	0.6	0.9	0.4
Equip. (Bils. 87 $'s)	-0.1	2.7	10.3	20.8	33.6	13.5
(Pct. Chg.)	-0.0	0.1	0.4	0.7	1.0	0.4
Consumption						
(Bils. 87 $'s)	-0.8	7.9	19.0	25.0	30.6	16.3
(Pct. Chg.)	-0.0	0.2	0.5	0.6	0.8	0.4
Real Net Exports						
(Bils. 87 $'s)	1.1	-1.8	-12.0	-18.6	-19.8	-10.2
Inflation - GDP Deflator						
(Pctg. Pts.)	-0.0	-0.1	0.0	0.0	-0.1	-0.0
Employment and Unemployment						
Payroll (Mils.)	-0.139	0.037	0.304	0.302	0.294	0.160
Unemp. Rate (%)	0.0	-0.0	-0.1	-0.1	-0.2	-0.1
Productivity Growth (Pctg. Pts.)	0.1	0.2	-0.0	0.2	0.2	0.1
Potential GDP						
(Bils. 87 $'s)	0.1	1.2	3.6	6.7	9.8	4.3
(Pct. Chg.)	0.0	0.0	0.1	0.1	0.2	0.1
Interest Rates (%)						
90-day T-Bill	-0.03	0.03	0.10	0.11	0.13	0.07
30-year Treas.	-0.14	-0.18	-0.15	-0.15	-0.17	-0.16
AAA-Equiv. Corp. New Issue	-0.16	-0.22	-0.20	-0.19	-0.20	-0.20
Aftertax Return on Equity	0.95	1.31	1.35	1.40	1.46	1.30
Cost of Capital (%)						
Pretax Equity	-0.74	-1.03	-1.09	-1.16	-1.22	-1.05
(Pct. Chg.)	-5.2	-7.2	-7.6	-8.0	-8.3	-7.3
Aftertax Wtd. Avg. Cost - Debt & Equity	-0.28	-0.38	-0.41	-0.44	-0.48	-0.4
(Pct. Chg.)	-2.8	-3.8	-4.1	-4.3	-4.5	-3.9
S&P500						
(Pct. Chg.)	0.2	1.1	1.7	2.0	2.4	1.5
Exch. Rate						
(Pct. Chg.)	-0.2	-0.3	0.2	0.1	-0.3	-0.1
Household Net Worth						
(Bils. $'s)	9.5	58.7	132.2	208.2	284.2	138.5
(Pct. Chg.)	0.0	0.2	0.5	0.7	1.0	0.5
Fed. Bdgt. Def. (NIPA)						
(Bils. $'s)	-3.5	-1.4	1.6	1.8	2.7	0.2
Personal Savings						
(Bils. $'s)	0.2	4.0	4.3	-2.4	-5.4	0.1
Business Savings						
(Bils. $'s)	4.6	9.3	10.7	11.8	13.8	10.0
National Savings						
(Bils. $'s)	1.1	12.7	17.8	12.3	12.5	11.3
National Savings Plus Earnings from Higher Realizations (Bils. $'s)	–	–	–	–	–	–

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.

** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.

Table 7
National Savings*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg Per Yr
National Saving	1.1	12.7	17.8	12.3	12.5	11.3
Personal Saving	0.2	4.0	4.3	-2.4	-5.4	0.1
Business Saving	4.6	9.3	10.7	11.8	13.8	10.0
Government Surplus or Deficit (-) (NIPA)	-3.6	-0.6	2.8	2.9	4.1	1.1
Federal	-3.5	-1.4	1.6	1.8	2.7	0.2
State and Local	-0.1	0.8	1.2	1.1	1.4	0.9

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.

Table 8
Federal Tax Receipts*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Cum. 1995-99
Total Receipts	-15.3	-16.9	-14.0	-15.2	-15.9	-77.2
Personal	-8.8	-10.7	-9.8	-11.0	-12.3	-52.6
Ordinary	-0.8	0.5	2.4	2.8	3.4	8.3
Capital Gains	-8.0	-11.2	-12.3	-13.8	-15.7	-60.9
Corporate	-5.6	-6.0	-5.5	-5.7	-5.3	-28.1
Ordinary	-0.4	1.2	2.2	2.7	3.9	9.7
Capital Gains	-5.2	-7.3	-7.8	-8.4	-9.3	-37.9
Excise	-0.0	-0.0	0.2	0.3	0.3	0.6
Social Insurance	-0.9	-0.1	1.3	1.3	1.4	2.9
Fed. Govt. Outlays	-12.1	-12.5	-11.1	-12.4	-13.8	-61.9
Purchases - Ex-Post	-8.1	-8.3	-7.4	-8.3	-9.2	-41.3
Transfers - Ex-Post	-4.0	-4.2	-3.7	-4.1	-4.6	-20.6
Ex-Ante (Static) Revenue Loss	-25.1	-36.3	-39.8	-43.8	-48.8	-193.8
Personal***	-14.8	-22.1	-24.8	-27.6	-30.9	-120.2
Corporate***	-10.3	-14.2	-15.0	-16.2	-17.8	-73.5
Exclusion***	-24.8	-34.8	-37.0	-39.4	-42.4	-178.4
Indexing***	-0.3	-1.5	-2.8	-4.4	-6.4	-15.4
Taxpayer Effect (Increased Realizations, LBGE)	10.2	15.7	16.6	17.6	19.1	79.2
Economic Feedback Effect (Increased Tax Receipts from Macroeconomic Feedback - LBGE)	-0.4	3.7	9.2	11.0	13.8	37.3
Ex-Post (Dynamic) Revenue Loss						
With Increased Realizations (LBGE)	-15.3	-16.9	-14.0	-15.2	-15.9	-77.2
With "Unlocking" Estimates						
Personal						
JCT (1)	-12.3	2.0	0.4	-0.3	-2.5	-12.6
OTA (1)	-12.5	2.4	4.4	1.8	0.7	-3.1
Pers. and Corp. (Corp. Est., LBGE)						
JCT (1)	-10.4	4.8	1.9	1.4	-4.2	-6.4
OTA (1)	-10.6	5.2	5.9	3.5	-1.0	3.1

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.
*** LBGE Estimate.
(1) JCT - Joint Committee on Taxation, 1990 estimate of Bush Administration capital gains proposal, no indexing.
OTA - Office of Tax Analysis, 1990 estimate of Bush Administration capital gains proposal, no indexing.

Chairman ARCHER. Thank you, Dr. Sinai.

Our last witness on this panel is Sheldon Cohen, former Commissioner of the Internal Revenue Service.

Welcome to the committee.

STATEMENT OF SHELDON S. COHEN, PARTNER, MORGAN, LEWIS & BOCKIUS, WASHINGTON, D.C., AND FORMER COMMISSIONER OF THE INTERNAL REVENUE SERVICE

Mr. COHEN. Thank you, Mr. Chairman. I am Sheldon Cohen, a partner in the Washington law firm of Morgan, Lewis & Bockius and speak for myself not for my law firm or for any of its clients. I am pleased at the opportunity to talk with you today.

I want to talk a bit about a tax system on which these changes will be imposed and how these changes might improve or deteriorate the administration of the tax laws. I think that is an important element here because we have a very fine tax system with a very low cost of administration. Indeed, our tax system as a whole collects about 29 and a fraction percent of our GDP as against 35 or more percent for any developed country. Our cost is much less than Germany, Japan, et cetera.

One of the things that we have to be careful of is that we keep it as a perceived fair system; that is, the taxpayers around the country must understand that they are being treated fairly. I believe you need a progressive system to do that or slightly progressive, and that is what we have today. It can be better, but beauty is in the eyes of the beholder there.

We have to be careful how we use those resources, that we don't skew economic planning by use of the tax system. Many of us would not vote for centralized economic planning in this country, and yet many of the same people would suggest tax deductions, tax credits, et cetera, which have the net effect of economic planning.

I prefer that the system work whereby lawyers, accountants, and businesspeople make decisions on the merits of the economy, the economic return from that investment, and that taxes be a cost at the end of the line that doesn't enter into the first decision that you make. One reason that I would avoid some of the credits and so forth that have been suggested is because they do come first.

The first decision will be made, can I get a tax benefit. We have had a great deal of that over the past number of years. The Tax Court has been full of cases, jammed with cases that revolve around tax benefits and very little economic benefit, and I think we have to avoid that.

The problem with refundable credits is that they will produce an action. You are putting a job on an agency that is an audit agency and you are putting a job that basically is a social work job. If you gave HHS $*x* billion and told them to give benefits to every child in the United States, you would put an obligation on HHS to audit more than eight-tenths of 1 percent of those people.

The IRS presently audits eight-tenths of 1 percent of all the people and it is on a sliding scale; the higher the income, the higher the percentage, so if you get into $30,000, $40,000, $50,000 brackets, you are talking one-tenth of 1 percent or less. I question whether you would put such a program in any agency with that little degree of supervision.

When we get over to the home office deduction, for example, I can understand a lot of people's unhappiness with the tight rule, but that tight rule was written in 1986 in exchange for rate reduction. If we break the package, we break the package. The difficulty is that back before 1986, everybody had in their apartment or house a room with a desk and that was their home office. I would hesitate to go back to that because once you loosen those rules, they basically become unenforceable.

The so-called neutral cost recovery system allows a very fast recovery of more than one's basis. We are back again to making decisions based on the tax benefits. If most of us remember the excessive rental property that was produced as a result of the depreciation benefits of 10 or 15 years ago, we produced a real estate debacle in effect by throwing benefits at real estate that were beyond what was needed.

I am not an economist, I am only a tax lawyer, but I see the way my clients make decisions, see the way other clients make decisions, and if they see a benefit, they go for it and they tend to push other considerations to the side. They go for the immediate benefit, so I worry about the "administrability" and decisionmaking that would result, particularly when you throw that together with capital gains at the disposition end.

When we get to capital gains, capital gains is a religion. Mr. Bloomfield believes in it and I don't. We have debated this a number of years and we like each other and don't get mad at each other. We have a capital gains tax break—in effect, we have one now, a 28 percent rate against a nominal rate of 39.6 percent, and there ought to be some benefit there. Whether that is enough, Mark and I would again debate that, and you might debate that. But throw it together with indexing and you have an interesting goulash.

Those people who go for indexing are the same people who say that we have too many regulations in the United States. You are going to get a thick book of how to apply indexing. It is not a simple concept, not easy to do. Recordkeeping will not be easy.

One can try to design a lot of rough and ready rules. They will either be too beneficial or too detrimental, I don't know which, but even if you write restrictive rules, the big six accounting firms, large law firms will be able to do it; the small businessman, the people that you ought to give the benefits to will not be able to do it. They will do it wrong and cause problems for themselves and the IRS. So I would ask you to go slow and think about the administratability of those provisions as well as the benefits that they might give.

My own view is that the best thing that you could do for capital formation is to reduce the deficit. A dollar's worth of deficit reduced is a dollar's worth of savings. The United States ran a very large capital surplus during the Korean war because it ran the Korean war basically on a balanced budget.

I am proud to say that I am the last Commissioner of the IRS to preside over a balanced budget. My last year in office was the last year the United States had a balanced budget.

Thank you, Mr. Chairman.

[The prepared statement follows:]

**STATEMENT OF SHELDON S. COHEN
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
January 24, 1995**

Mr. Chairman and distinguished members of the Committee:

My name is Sheldon S. Cohen. I am a partner in the law firm of Morgan, Lewis & Bockius in the D.C. office. It is my pleasure to appear before you today to present my personal views on some of the tax proposals contained in the "Contract with America." My comments will reflect my opinions regarding our Federal tax system and the principles that I believe are vital to the support and maintenance of the system. My views have evolved over many years of working in the area of taxation on both sides of the table: within the IRS as one of the drafters of the 1954 Code under President Eisenhower, and as Chief Counsel and Commissioner of Internal Revenue in the Johnson administration as well as in private practice as an attorney frequently representing clients. I speak here for myself, not for my firm or any of its clients. You might be interested to note that I was Commissioner of the IRS the last time the United States had a balanced budget, (fiscal 1969).

In light of all the recent criticism about our tax system, it is interesting to note that we have the finest tax system with the lowest cost of collection of any of the developed countries of the world. (Indeed, our overall tax collection, state, local and federal, is lower than any of the other developed countries.) In order for our self-assessment tax system to function well, it must be perceived by the taxpayers as a fair system. In my experience, fairness requires that an individual's tax burden be based on his or her ability to pay. This, in turn, requires a reasonably progressive rate structure. The rate structure does not make a tax system complex. It is deductions and credits, which require careful definition, that make the system complicated. Moreover, perceived fairness of the system cannot be maintained if taxpayers believe that, somehow, there are loopholes available to well advised taxpayers which enable them to escape their fair share of the tax burden. An overly complex system contributes to the perception of unfairness. Confidence in the system is a fragile balance. We should do nothing to lessen compliance with our tax laws as they are the sinews which hold government together. I have been all over the world working with developing countries to improve their systems; they all envy ours.

Experience has taught me that the tax system should not direct the utilization of our nation's resources. Commercial and financial transactions should be driven by economic and business considerations, not by tax considerations. It is interesting that many of those who do not believe in centralized government economic planning will suggest a tax deduction or credit which has the effect of imposing a centralized economic plan. As a practicing tax lawyer, I, and many of my brethren, have spent too much time and energy addressing client concerns, not about the legal or economic aspects of the investment, but about the size of the tax "write-offs." Memories are still fresh of the collapse of the rental real estate market, caused, in part, by overdevelopment facilitated by depreciation deductions that made the availability of tenants almost an afterthought. Let us not return to the days of the "tax shelter society."

We all know that the integrity and efficiency of the IRS is the cornerstone of an effective tax system. I think it is counter-productive to use the IRS as the administrative institution to implement and administer a broad range of social policies. These burdens are ill suited to the skills needed by tax administrators and cause a diversion of resources away from the Service's important traditional functions. I have said before this Committee in the past, when it was controlled by the other party, that you can accomplish almost any program by use of the tax system. Thus, if you push this too far you could abolish many departments of the government and use the IRS to hand out agricultural subsidies, child care benefits, veterans benefits, business incentives and on and on. All this would, of course, bring down the system. With each added item, the IRS becomes less effective and the Code a jumble of conflicting provisions. We must be careful not to go too far afield with the tax system.

I approach the "Contract with America" with these principles and opinions in mind.

A number of the social programs that are contained in the Contract with America are funded through a technique referred to as the refundable tax credit. These programs are: (i) the $500 per child refundable tax credit; (ii) the $5,000 refundable tax credit for adoption expenses; and (iii) the $500 refundable tax credit for elderly care.

Some of these social programs may be worthy in purpose and address the concerns of many Americans. Perhaps there is room for discussion regarding the effectiveness of these programs and the precise targeting of the benefits. I might target them at one group in society while some of you seem to direct these benefits at everyone -- at a greater cost. My concerns, however, deal with the problems of administering and auditing these benefit programs within our present system of tax administration and enforcement.

No doubt the refundable tax credit technique has appealing features; after all, the IRS already administers other deductions, credits and refundable tax credits, and almost everyone files a tax return. I assume the authors believe that it is relatively simple to reduce tax liability by the amount of the credit, or to request a refund to the extent the amount of refundable credit exceeds tax liability. I submit, however, that notwithstanding the asserted ease of administration, the refundable tax credit technique forces the IRS into the business of administering social programs for which it does not have the skill or experience. This will result in high cost administration coupled with a low level of accountability from the beneficiaries of the programs. It will also denigrate the existing tax administration since new resources are not provided.[1/]

The $500 credit is given to everyone except for the upper one percent of taxpayers. I suspect that many people earning over $100,000 would enjoy the credit but do not in my judgment have need of it. How much lower than $100,000 the limit should be is a judgment call.

The Congress would, I believe, insist that a social work agency have strict accountability before paying out benefits under a program such as one providing a $5,000 payment to defray adoption expenses. Yet, upon the receipt of a tax return claiming a tax credit for adoption expenses, it is likely that the IRS would accept a reduced tax payment or authorize cash disbursement to the taxpayer. It does not have the staff to check on this or if it attempts to use existing staff it will be at the expense of revenue agents who are in sorely short supply

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1/ I would remind the Committee of the furor caused by the proposal of candidate George McGovern in 1972 that there be a grant of $1,000 to every man, woman and child in America to alleviate poverty. I opposed that idea on administrability, as well on other grounds.

now. I'm sure that even the $500 child credit will create more incentive for cheating. After all, by listing one more child, I get a check for $500 and the IRS has the burden of checking on me.

The IRS is not the kind of agency to oversee or enforce a social program utilizing refundable tax credits. At present, the IRS examines a very limited number of returns (substantially less than 1%). Moreover, most of the returns filed by persons qualifying for the benefits provided under these tax credit programs are not ordinarily selected for audit. The number of audits tends to be higher for the complex high income returns and lesser for simpler low income returns. It is unlikely that Forms 1099 or other similar verification will be available to prevent the payment of tax benefits in cases involving taxpayer mistakes or fraud. Indeed, we see a high incidence of mistakes and fraud on the earned income tax credit now. I believe these new proposed programs would engender similar cheating. If the verification burden falls on the IRS personnel, then resources that would normally be assigned to audits of complex high income returns, will be diverted to monitoring social welfare programs -- an inefficient use of resources by any standard.

It is likely that the IRS will have problems monitoring taxpayer compliance under other provisions of the Contract with America. For example, under an American Dream Saving Account ("ADSA"), penalty free withdrawals would be allowed after five years for the purchase of a first home, higher education expenses, or medical expenses. Again, the compliance issue centers on difficulties of verification. For example, if the ADSA account requires the financial institution to issue a Form 1099 (or similar information return) upon a purported penalty-free withdrawal event, verification of the bona-fides of the withdrawal would require an audit of the return. The limits on the number of returns that can be selected for audit would either prevent any meaningful verification of ADSA withdrawals or would divert the IRS from auditing other, higher priority returns. In any event, there is no evidence from our prior experience with IRAs that this program would markedly increase savings in this country.

Any expansion of the home office deduction is likely to expand the possibility of taxpayer abuse in this area of the tax law that traditionally has been the subject of abuse. That was the reason the Congress toughened these rules in 1986. Many of us can remember when it seemed that every home in America had a room with the mandatory desk and bookcase that, presumably, was set aside for some business activity or another and for which tax deductions were taken. (As I recall, the Congress in 1986, with the Reagan Administrations concurrence, traded the lowering of tax rates for the elimination of deductions).

Speaking of the bad old days, I would like to address the neutral cost recovery system and the capital gains preferences as provisions that have the potential for tax shelter activity and for directing investment on the basis of tax benefits rather than pre-tax economic return.

The neutral cost recovery system provides special tax incentives for investment in short-lived tangible assets based on an indexing system that exceeds the inflation rate. As a result, the amount of depreciation over the life of some assets will exceed the cost of the assets. These special tax incentives likely will cause taxpayers to modify their behavior by making investment decisions based on tax considerations rather than on economic considerations (particularly when coupled with the capital gains proposal). As I have stated, a well-ordered tax system should not cause this result. We have only recently seen the backlog of the shelter cases in the Tax Court and Appeals

Division of IRS fall off. These suggested new shelters will again cause disruption.

The long-standing debates continue over the fairness, cost and economic efficacy of preferential treatment for capital gains. Some in the debate center their ideas on the use of preferential rates; others on the use of an indexing system. The provisions in the "Contract with America" contain both types of preferences. There may be some merit on either side of the debate. This area has become one of religious belief. There is no certainty on either side of the argument. If I had to choose, my personal choice is for no special capital gain preference but I can see the idea of a simple and modest capital gain preference -- somewhat as we have in present law (where the maximum capital gains rate on individuals is 28% as against a nominal high rate of 39.6%).

Simplicity is not the hallmark of an indexing system. Incredible complexity is almost certain to accompany any system that can be applied to the variety of special situations we can all envision. Such complexity is likely to present a costly burden to the IRS and a bewildering array of rules to the average taxpayer.[2/] One of the concerns of the Contract is the excessive rules and regulations with which it contends we all live. The contract provisions on indexation would markedly increase the volume of regulations needed to implement such a complex provision. Moreover, I would be deeply troubled by tax policy concerns over the results of indexing assets without indexing the debt incurred to acquire those assets. If I buy a machine with 100% debt, why do we index the machine, but not the debt. I pay off the debt with depreciated dollars. I prefer no indexing but if we go for the complexity, we need it to work fairly.

While some aspects of the capital gains preference issue are debatable, there should be absolutely no question that large differences between the tax treatment of ordinary income and capital gains spawn tax planning activity designed to convert ordinary income into capital gains and to shift the benefits of capital gains to high-bracket taxpayers. The results of this planning may be lucrative for the players and their tax advisors but is costly to the economy and destructive to the tax system. Moreover, a revival of the gamesmanship surrounding capital gains conversions will force me to brush up on the collapsible corporation rules, a painful exercise I would prefer to avoid.

My comments, today, are offered in the hope that the work of this Committee will strengthen the integrity of the Federal tax system. The American taxpayers deserve and expect a tax system that is fair, administrable and economically neutral. I hope that goal can be achieved through your work. I would be glad to assist you and your staff to achieve such a goal.

2/ I have often discerned that taxpayers only complain about complexity when the rules are ones they do not like; they do not seem to mind complex provisions which are beneficial.

Chairman ARCHER. Thank you, Mr. Cohen.

If we make judgments as to which provisions are to be put in the Tax Code strictly based on difficulty of administration, would you suggest to this committee that we abolish the foreign source income tax provisions in the current Tax Code?

Mr. COHEN. I think those rules are terribly complex and I would try to make them more simple. The difficulty is that anything that is so complex that it takes a special category of people like me who administer them, you have perceived unfairness.

Now, you have a variety of provisions in the law that are terribly complex and were put there to ameliorate some problem or other. It would be better if we could do it some other way. I am not saying that you shouldn't do anything that makes the law more complex but that you must think carefully when you make the law complex because the compliance rate in the United States is in the 80th percentile now.

When I was in office 25 years ago, it was the 90th percentile. When you think about 1 percentage slip in compliance, you are talking about more revenue than you are talking about in most of these measures.

Chairman ARCHER. Well, I would simply submit to you that we looked very carefully at foreign source income on several occasions and, at the end of those deliberations, we made it more complex. That did not seem to deter this committee from doing that. I would also submit that the complexity of the foreign source income provisions would make indexing look very, very simple.

Dr. Sinai, let me inquire of you, because you are reputed amongst many sources in this country as having one of the best models for looking at capital gains and its impact on the economy. I am curious as to whether you have done any rough tabulation on the capital gains provision that is in the Contract With America and, if so, could you tell us what impact you believe it would have on revenues?

Mr. SINAI. The tax reductions are unique, as you know, because of the unlocking effect and the effect potentially on the stock market, also on the economy, I would submit, and what that means for the induced tax revenues to the government. I don't know of any other tax that is quite like this. So what we gained when we simulated this is that our economic activity is greater, economic growth is stronger.

We do generate and increase business savings and personal saving. I am now talking about a situation where we wouldn't finance this with cuts in government spending, and we increase productivity and potential output. That brings some extra revenues in and a somewhat better stock market increases realizations and then, at the lower tax rate, more taxes come into the government. Net-net, the particular proposal that is in the Contract With America, after these feedback effects, without making an assessment of the full unlocking effect, cost $62 billion over 5 years. That is about $12 billion a year. We haven't done our own independent estimates of unlocking.

I don't think the proposal has been evaluated yet in terms of what the unlocking effects would be, but there is a vast majority of opinion, academic and otherwise, that says there really is unlocking. So that $62 billion cost has to be, I think, reduced once you add the effect of unlocking. Whether it would fully pay for itself or not, I don't know. It depends on the unlocking numbers used.

But I could cautiously say that a capital gains tax reduction has the best shot of any tax of perhaps paying for itself, all things considered. When we have looked at the model simulations, what it does to saving, investment, and the economy, and though it is not a big potatoes thing in a $6.8 trillion economy, it is a big enough thing that it really does move the economy in the direction that you talked about in your opening comments, Chairman Archer.

So I have to be of all—if I have to pick one of what is being talked about here, this would be the one that at this time in our economy I would favor.

Chairman ARCHER. I am a little reluctant to ask you the next question, but I am going to do it anyhow.

Mr. SINAI. I appreciate your comments about the model.

Chairman ARCHER. I would like you, if you are willing to do so, to characterize yourself to this committee as to whether you believe yourself to be a liberal, moderate, or conservative economist.

Mr. SINAI. Yes. That is an interesting question, Mr. Chairman. I think it is in the eyes of the beholder. I suspect that in my research and my opinions, sometimes I strike people as being liberal, sometimes conservative and maybe most of the time they can't understand what I am talking about. So I don't really put myself in either of those.

And with all due respect to Democrats and Republicans, both of whom I provide advice and information to, I am happy to do so as a citizen of the country, I am independent politically and that independent doesn't mean I am a Perot supporter. The research drives me so I would refuse to be labeled any of those. If someone, because I have said what I just said about capital gains, thinks I am conservative, that is for them to say. I wouldn't say it.

Chairman ARCHER. You think of yourself as being mainstream?

Mr. SINAI. I think of myself as being evidential. In forecasting, there is no doubt I can change my mind at any time.

Chairman ARCHER. Let me ask you and Mr. Bloomfield a question that has troubled me over the years. We talk a great deal about incentives for new savings and I believe that that is very, very important. I think all three of you probably agree that that is important, but very rarely do we hear anyone speak of existing savings.

Are not existing savings important, particularly if they are given flexibility to seek their highest and best use in the marketplace? In fact, are they not on a par with new savings inasmuch as new savings merely become mixed in an existing savings pool as soon as they are saved and become a part of existing savings?

Mr. SINAI. Well, Mr. Chairman, I think what you say is true in a qualitative sense and in a practical sense. It is not always so fungible. It is not easy for the forms in which savings are held to be moved from one use to another. But, generally, markets will do in terms of incentives what you think.

On the margin, what will move markets more, of course, are the marginal funds flows. That is often why there is stress on that.

Mr. BLOOMFIELD. Mr. Chairman, I would add that one of the critical factors, particularly with capital gains, is the lock-in effect and to the extent to which you have a capital gains tax cut, you will have a lot of unlocking. And I think that would be helpful for small business and others that are looking for capital. That capital may never be unlocked without a capital gains tax cut.

I would also like to comment about the revenue implications of capital gains that Dr. Sinai talked about. Dr. Sinai looked at the macroeconomic impact of capital gains. In his testimony, you will see that he estimates that a capital gains cut creates about 1 million jobs over 5 years and it has a significant impact on investment which is critical to long-term economic growth.

Harvard Professor Dale Jorgenson, who will be here I think 2 days from now, just published a book indicating that the most important factor for long-term capital growth is capital stock. I think that what you have in capital gains is a tremendous impact on investment, which is important for long-term economic growth.

In other words, Dr. Sinai talked about the macroeconomic impact of capital gains. There are two other aspects that affect the revenue impact. One is the historical data. If you look at the historical data and you look at the period when we did have a capital gains experiment which was the period 1978 to 1985, what happened in that period?

In 1978, capital gains receipts were $9 billion, in 1985 they were $27 billion. That cannot be explained only by economic growth and the stock market. What would apply is higher capital gains revenue at lower rates.

The second example that I would like to use in terms of historical data is the period subsequent to the 1986 tax bill. What happened with the 1986 tax bill, of course, was a tremendous unlocking in 1985. In 1985, capital gains receipts were $49.7 billion, and they have not recovered to that level. They dropped in 1986 under the new regime to $32 million, and now capital gains receipts are only $29 billion. I think that says something about capital gains receipts and tax rates because, in the period 1987 to 1992, there was an increase in the economy and inflation.

Let me finally comment about the whole question of unlocking and revenue estimates. This may sound contrarian, but there is not that much of a difference of opinion among economists, I am talking about the Joint Committee on Taxation and the Treasury, about unlocking. Let me give you an example.

When the Bush proposal for a 30-percent exclusion was before the committee, the static revenue loss of the Bush proposal was $100 billion. The Joint Committee on Taxation estimated that unlocking alone over 5 years would recoup 90 percent of that static revenue loss. The Treasury Department assumed that unlocking would recoup 110 percent of the revenue loss. So if you look at the amount in the aggregate, unlocking almost does it.

As you go through revenue estimates, we have a Treasury revenue estimate of the capital gains provisions of the Contract, we have Dr. Sinai's revenue estimates which show that with macroeconomic feedback, that after 5 years you do have a revenue impact which is positive in addition to the jobs created. But the Joint Committee numbers we haven't seen yet.

I would suggest that, since unlocking is not a macroeconomic argument but a very technical argument about how much unlocking you are going to get, as you look at the revenue estimates, you probably will have a range from A to D where D might be a revenue loss in the range of $50 billion and A would be a revenue loss in the range of about $2.5 billion. This committee might line up those revenue estimates and understand that these are very, very technical and they are also very, very credible numbers. These are not far out things.

In that sense, the unlocking is something which is a mainstream argument, something we should look at carefully. I think even before you get in the macroeconomic analysis of the revenue impact, you are going to be pretty close to avoiding a big revenue loss.

Chairman ARCHER. Thank you very much.

Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman. I would just note that in Dr. Sinai's testimony, I think he emphatically points out that none of these tax proposals would be beneficial in a fully employed economy if budget deficits were to rise significantly.

It is interesting to note that in his testimony, he has a total tax reduction 5-year cost of $193 billion. And the Senate Budget Committee came out with a 5-year tax cost of $188 billion. Not bad.

The Senate's proposal to pay for this would cut nondefense discretionary spending by $252 billion, and most of that I suspect would be to cut entitlements with the exception of Social Security by $580 billion, arguably cuts to the lowest income people in the country.

So I ask my friend, Sheldon Cohen, in your experience and reviewing what we have done and the number of taxpayers and whether they are rich or very low or middle income, how would you assess the distribution of these cuts? Would most of them go to the upper 2 percent of Americans, 1 percent, 5 percent, half of the American taxpayers?

Mr. COHEN. I was rather surprised that, for example, the $500-per-child credit went all the way up to $250,000. You are talking there about a fraction of 1 percent of the population. If you got down to $100,000, you would be talking about the upper 2 percent of the population so that those benefits flow across the board.

When you are talking about the depreciation, capital gains combination where the big money is, those cuts go predominantly to the upper 5 to 10 percent of the population. Most of the capital gains activity in the United States is in the upper 5 percent of the population.

Mr. STARK. Where do you find the largest amount of the entitlements excluding Social Security? You take most of that out of Medicare, but those would go to the seniors, 40 percent of those are poor.

Mr. COHEN. Older people would be lucky if they had $40,000 income, so you are talking about the average income in the United States is in the low thirties, so you're certainly talking well below the average.

Mr. STARK. So it would be a fair estimate to say that what this plan would do is give $188 billion of incentives or rewards or bonuses to those at least in the richest 10 percent and at the same time taking three times as much away from the lowest 40 percent of people in income, those people below arguably $30,000 a year; is that a fair assumption?

Mr. COHEN. Yes, sir.

Mr. STARK. How would your model deal with that, Dr. Sinai?

Mr. SINAI. I think capital gains tax reductions benefit higher income families compared with lower income families. The cuts you describe would do the same; it would be an increase in the inequity of income distribution that has happened over the last 10 or 12 years.

If one weights very highly that particular dimension of capital gains tax reduction, you have to be against it. I understand and respect that view. That is one of the criteria by which we judge tax changes.

On the other criteria——

Mr. STARK. We could do it other ways. If capital gains is very important, we could pay for it by distributing the cuts more to those upper-income people as well, could we not?

Mr. SINAI. Yes. The other dimensions of capital gains tax reduction, growth, the ability to compete internationally on cost of capital grounds, we have the highest capital gains taxes of any of the countries on the list. Many of them have no capital gains taxes. The jobs effect, these are the dimensions that are also very important and each individual weights them differently.

My judgment is, capital gains tax reduction wins on four out of five criteria, even admitting for the effect you talk about. So I think it is a good thing to do. The tax cuts you describe sound large to finance, $188 billion over 5 years. We did in the model do simulations where we cut spending and some transfers by $190 billion, the amount of the static revenue losses, and I could provide those results to you.

Mr. STARK. In your testimony, you show $193 billion in cuts.

Mr. SINAI. That is the static revenue loss.

Mr. STARK. The Senate showed $188 billion.

Mr. SINAI. We are very close. We have done model simulations of both cutting spending and transfers by $190 billion to see what it does and what was reported in the testimony would cut spending and transfers by $62 billion, which was the ex-post revenue loss. I would be happy to provide the former to the committee as well.

[The following was subsequently received:]

Table 9
Macroeconomic Effects of a Capital Gains Tax Cut*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
Real GDP - Level						
(Bils. 87 $'s)	-14.3	-1.9	7.3	7.9	16.3	3.1
(Pct. Chg.)	-0.3	-0.0	0.1	0.1	0.3	0.0
Real GDP-Growth (Pctg. Pts.)	-0.3	0.2	0.2	0.0	0.1	0.1
Business Capital Spending						
Total (Bils. 87 $'s)	-0.5	7.3	14.7	19.4	24.6	13.1
(Pct. Chg.)	-0.1	1.0	1.9	2.4	2.8	1.6
Plt. (Bils. 87 $'s)	0.4	4.2	6.9	8.1	9.3	5.8
(Pct. Chg.)	0.2	2.5	4.1	4.5	5.0	3.3
Equip. (Bils. 87 $'s)	-0.9	3.1	7.8	11.3	15.3	7.3
(Pct. Chg.)	-0.2	0.5	1.3	1.8	2.3	1.1
Capital Formation - Stocks						
Plt. (Bils. 87 $'s)	0.1	2.6	8.5	15.6	23.4	10.0
(Pct. Chg.)	0.0	0.1	0.3	0.6	0.9	0.4
Equip. (Bils. 87 $'s)	-0.6	0.7	6.5	15.1	25.9	9.5
(Pct. Chg.)	-0.0	0.0	0.2	0.5	0.8	0.3
Consumption						
(Bils. 87 $'s)	-3.9	-0.6	5.5	7.2	10.9	3.8
(Pct. Chg.)	-0.1	-0.0	0.1	0.2	0.3	0.1
Real Net Exports						
(Bils. 87 $'s)	3.0	6.8	1.6	-3.0	-2.9	1.1
Inflation - GDP Deflator						
(Pctg. Pts.)	-0.1	-0.2	-0.1	-0.0	-0.1	-0.1
Employment and Unemployment						
Payroll (Mils.)	-0.238	-0.222	0.013	-0.031	-0.071	-0.110
Unemp. Rate (%)	0.1	0.1	-0.0	-0.0	-0.0	0.0
Productivity Growth (Pctg. Pts.)	0.1	0.3	-0.0	0.1	0.2	0.2
Potential GDP						
(Bils. 87 $'s)	0.1	1.1	3.5	6.8	10.0	4.3
(Pct. Chg.)	0.0	0.0	0.1	0.1	0.2	0.1
Interest Rates (%)						
90-day T-Bill	-0.07	-0.05	0.01	0.01	0.01	-0.02
30-year Treas.	-0.18	-0.26	-0.27	-0.29	-0.32	-0.26
AAA-Equiv. Corp. New Issue	-0.20	-0.31	-0.32	-0.34	-0.37	-0.31
Aftertax Return on Equity	0.95	1.31	1.35	1.40	1.46	1.29
Cost of Capital (%)						
Pretax Equity	-0.75	-1.03	-1.09	-1.17	-1.24	-1.05
(Pct. Chg.)	-5.2	-7.2	-7.6	-8.0	-8.4	-7.3
Aftertax Wtcd. Avg. Cost - Debt & Equity	-0.29	-0.39	-0.43	-0.48	-0.53	-0.4
(Pct. Chg.)	-2.9	-4.0	-4.3	-4.6	-5.0	-4.2
S&P500						
(Pct. Chg.)	0.2	1.3	2.0	2.6	3.5	1.9
Exch. Rate						
(Pct. Chg.)	-0.5	-1.1	-0.5	-0.4	-0.8	-0.6
Household Net Worth						
(Bils. $'s)	5.0	29.8	66.1	102.3	143.4	69.3
(Pct. Chg.)	0.0	0.1	0.3	0.4	0.5	0.2
Fed. Bdgt. Def. (NIPA)						
(Bils. $'s)	2.4	12.1	22.6	27.8	33.1	19.6
Personal Savings						
(Bils. $'s)	-2.7	-2.0	-0.8	-6.3	-6.9	-3.8
Business Savings						
(Bils. $'s)	223.9	249.5	275.5	304.7	338.7	278.5
National Savings						
(Bils. $'s)	223.0	260.1	298.6	327.7	367.3	295.3
National Savings Plus Earnings from Higher Realizations (Bils. $'s)	–	–	–	–	–	–

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.

Table 10
National Savings*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
National Saving	223.0	260.1	298.6	327.7	367.3	295.3
Personal Saving	-2.7	-2.0	-0.8	-6.3	-6.9	-3.8
Business Saving	223.9	249.5	275.5	304.7	338.7	278.5
Government Surplus or Deficit (-) (NIPA)	1.9	12.6	23.9	29.3	35.5	20.7
Federal	2.4	12.1	22.6	27.8	33.1	19.6
State and Local	-0.5	0.6	1.3	1.6	2.4	1.1

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.

Table 11
Federal Tax Receipts*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Cum. 1995-99
Total Receipts	-18.1	-23.0	-21.8	-24.8	-26.7	-114.3
Personal	-9.8	-13.2	-13.0	-15.1	-17.2	-68.3
Ordinary	-1.7	-1.7	-0.5	-1.0	-1.1	-6.2
Capital Gains	-8.1	-11.4	-12.5	-14.1	-16.0	-62.1
Corporate	-6.6	-7.5	-7.1	-7.2	-6.2	-34.5
Ordinary	-1.4	-0.1	0.7	1.3	3.2	3.7
Capital Gains	-5.2	-7.3	-7.8	-8.5	-9.4	-38.3
Excise	-0.0	-0.0	0.2	0.3	0.3	0.6
Social Insurance	-0.9	-0.1	1.3	1.3	1.4	2.9
Fed. Govt. Outlays	-25.1	-36.3	-39.8	-43.8	-48.8	-193.8
Purchases - Ex-Post	-16.9	-24.2	-26.6	-29.2	-32.5	-129.4
Transfers - Ex-Post	-8.2	-12.1	-13.2	-14.6	-16.3	-64.4
Ex-Ante (Static) Revenue Loss	-25.1	-36.3	-39.8	-43.8	-48.8	-193.8
Personal***	-14.8	-22.1	-24.8	-27.6	-30.9	-120.2
Corporate***	-10.3	-14.2	-15.0	-16.2	-17.8	-73.5
Exclusion***	-24.8	-34.8	-37.0	-39.4	-42.4	-178.4
Indexing***	-0.3	-1.5	-2.8	-4.4	-6.4	-15.4
Taxpayer Effect (Increased Realizations, LBGE)	10.2	15.7	16.6	17.6	19.1	79.2
Economic Feedback Effect (Increased Tax Receipts from Macroeconomic Feedback - LBGE)	-28.3	-38.7	-38.4	-42.4	-45.8	-193.5
Ex-Post (Dynamic) Revenue Loss						
With Increased Realizations (LBGE)	-18.1	-23.0	-21.8	-24.8	-26.7	-114.3
With "Unlocking" Estimates						
Personal						
JCT (1)	-15.1	-4.1	-7.4	-9.9	-13.3	-49.7
OTA (1)	-15.3	-3.7	-3.4	-7.8	-10.1	-40.2
Pers. and Corp. (Corp. Est., LBGE)						
JCT (1)	-13.2	-1.3	-5.9	-8.2	-15.0	-43.5
OTA (1)	-13.4	-0.9	-1.9	-6.1	-11.8	-34.0

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.
*** LBGE Estimate.
(1) JCT - Joint Committee on Taxation, 1990 estimate of Bush Administration capital gains proposal, no indexing.
OTA - Office of Tax Analysis, 1990 estimate of Bush Administration capital gains proposal, no indexing.

Mr. SINAI. You will get a much bigger gain in national savings, but by $190 billion of cuts out of the government side you are going to lose a lot of macrostimulus because it has negative effects. One issue is how much do you have to cut outlays to finance whatever estimate of the revenue losses you use.

Mr. STARK. Did you not find in your testimony that the dream savings accounts do little to increase overall savings but lead to switching existing savings into tax-deferred accounts?

Mr. SINAI. That is an opinion based on others' research. We have not quantitatively analyzed that. Years ago, I did an analysis of the IRAs in place at that time and came to the conclusion there was more switching in savings allocations than stimulus to saving. This one, because of the tax-free drawing on it for various advances could provide a bigger incentive to saving. It is different from the past IRAs. I don't think it will raise the savings rate very much, if at all, but that is an opinion. I haven't done the real research on that yet.

Chairman ARCHER. The gentleman's time has expired.

Mr. Crane.

Mr. CRANE. Thank you, gentlemen, for your testimony. Back when my son was a teenager, I remember one summer he had a job and I counseled him not to blow his paycheck at the end of the week on instant gratification but put something away for the proverbial day. He said, "That's nuts, daddy." I said, "What do you mean, George?" He said, "Daddy, if I blow it at the end of the week, they only get at it once."

I thought about that. I invest my saved dollar and invest in a public corporation. When they make a profit, it gets taxed a second time; dividend distribution, it gets hit a third time. I sell my stock and enjoy a capital gain and it gets hit a fourth time. And the ultimate obscenity in our code, in my estimation, is when you have the audacity to die and leave, then they come in and bash your bereaved spouse and loved ones.

I personally believe that we have one of the most reprehensible Tax Codes on the face of this Earth. It does violence to the values that I was brought up to believe in. I don't believe we should tax interest, dividends, or capital gains at all.

The fact of the matter is, if you have denied yourself instant gratification, why can't you put that dollar to work for the rest of that dollar's life and let it grow and develop interest? Hopefully that would put you in a position at some point to pass it on to a loved one when you shuffle off this mortal coil.

In that context, we have debated this question of reducing the capital gains tax. I remember in 1978, when Billy Steiger took the rate down to 28 percent and we got a lot of static revenue assessment about a revenue loss when it actually increased revenues. We heard that again in 1981.

When we took the rate back up in 1986, we had an executive session of the Ways and Means Committee over in H–137 and there was a fellow from Treasury sitting beside me who had scored this as a $25 billion revenue raiser over the next 5 years.

I said, "How can you come to that conclusion based on our experience?" He said, "You have to understand that this bill doesn't go into effect until January 1, 1987, but the fiscal year starts

October 1, 1986. We anticipate raising $20 billion of that between October 1 and December 31," which they did.

If you look at the figures, you had $326 billion in capital gains realizations in 1986 because of that anticipated hike. That then dropped the next year down to $144 billion. The actual Treasury revenues were $49.7 billion in 1986, and that dropped to $32 billion the next year. Looking at these figures causes me to ask a question. If your objective is to maximize revenue and maximize the creation of venture capital at the same time, I have heard reports that the ideal rate, assuming you feel determined to tax capital gains, should be between 9 and 12 percent. Have you got any material or do your studies indicate anything to confirm that?

Mr. BLOOMFIELD. Mr. Crane, the 9 to 11 percent rate is based on some work done at the National Bureau of Economic Research that Dr. Feldstein heads, and that is the result of work there. It is also the result of work done by Larry Lindsey, who now serves on the Federal Reserve Board. In prior years, he looked at the various economic models, and he looked at data, and that is sort of the rough range that he came up with, which was 9 to 11 percent. Now, obviously, with your proposal, you are at 19.8 percent, but you have indexing, so you are beginning to get down to that level.

What I am concerned about, that at some point if you do not have a significant capital gains tax cut, which you have, it is not worth doing, so I think you need to get to that range.

Mr. CRANE. You know something else, in that connection, I have a graph that goes back to the late eighties which indicates by quintiles the beneficiaries of the capital gains tax cuts. The graph shows that 75 percent of those beneficiaries of a capital gains cut are in the $50,000 and under bracket, and 90 percent of the beneficiaries have incomes under $100,000. The Treasury Department gave us these figures and I'm wondering if the panel would comment.

Mr. COHEN. Those are the beneficiaries, Mr. Crane, not the dollars.

Mr. CRANE. The beneficiaries, yes.

Mr. COHEN. But if you looked at the dollars, it skews the other way.

Mr. BLOOMFIELD. Well, Mr. Cohen, there is a point that Mr. Crane is making that is very legitimate and that is when the IRS looks, when the Joint Committee looks at income distribution, it assumes that the same taxpayer has a capital gain every year, which is distortionary. You take a person who earns $50,000 and his spouse earns $50,000 and they sell their business, they are a $200,000 taxpayer.

What CBO and others have done, they have always assumed that it was the same taxpayer. In fact, it is not. If you look at IRS statistics, you find out that 44 percent of all taxpayers realize a capital gain only once in 4 years.

If you look at the numbers you are talking about, Mr. Crane is correct. Half of all dollars of capital gains go to taxpayers with salary income of less than $50,000. If you look at filers, 75 percent of all returns that have capital gains have salary incomes of $50,000 or less. I am not disagreeing with the fact that I think Mr. Stark would make that a lot of upper-income people have capital gains, but there is a heck of a lot of middle-class people who have capital gains, too.

Mr. CRANE. Could I make just one final comment, regarding the percentage of taxes paid by income groups, the top 10 percent in 1992 paid 57.5 percent of the total taxes, the top 50 percent paid 94.9 percent. The fact of the matter is these are the people who are paying the taxes, and I think they are entitled to some relief for doing the right thing.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Thomas.

Mr. THOMAS. Thank you very much.

One of the more frustrating things for me, especially last year in dealing with health care and in cosponsoring a super IRA bill along with then-Senator Bentsen and Roth and Jake Pickle as I continue to do, is the frustration in dealing with both the budget environment in which the world has to be looked at in 5-year increments and nothing exists beyond that, and as our colleague from California did, the penchant of examining tax policies through tax distribution charts in terms of who gets the benefit on a straight analysis of who benefits immediately.

Going back to my friend from Illinois' family analogy, if we sat around the table and talked about a distribution of family income on a distribution chart basis, my kids would want to claim far more than I let them claim, because I happen to think that the way in which I want to use the money has a superior calling than the way in which they want to use the money. Mr. Cohen, you are right. Paraphrasing the "Field of Dreams" in terms of tax breaks, if you give it, they will take it. I understand that, but my question is in terms of this whole business of deferred gratification. On an individual basis it is good for the soul, but I believe collectively it is good for society in ways that I would hope we could break out of the tax distribution models or the 5-year model.

You can deal with a Tax Code which people see as a higher good of building see-through office buildings, both literally or figuratively, or you can have a Tax Code which encourages people to put their own money away to take care of themselves at some future time. Frankly, they are both tax breaks if you look at them that way, but I happen to see a qualitative and a quantitative difference, and unfortunately it almost always has to get outside of the 5-year window or the distribution charts.

How do we break out of, or should we break out of, this conceptual framework of the 5-year budget window or the decision has to be made on a realtime basis in a distribution of tax benefits where people at the lower end of the income have to get the same deal as people at the upper end?

I will just throw it open to anybody who wants to respond.

Mr. SINAI. I don't know how you can design something that at the same time will give everybody equal benefit from some public policy change on taxation or spending. Where I come down is these days because we are close to full employment, is looking very positively at measures and actions in Washington that raise productivity growth and increase the rate of growth of potential output.

Now, that supply side growth of potential output, which has been very anemic for so many years and is now creeping up, estimated now at 2½ percent a year, it used to be 3 percent a year, if we could pump that up and grow 3 percent a year, then the central bank would not next week be thinking about raising interest rates, which punishes everybody, upper and lower income families, so that, to me, gets out of this looking at it on the 5-year horizon and looking at it trying to make it work for everybody at the same time.

I do want to point out that the higher income families do save more, and if the goal is savings and investment, more will flow that way. I do want to point out also that a lot of other countries we compete with internationally have no capital gains taxes, that includes Germany, and Japan has a much lower one than we have, and there are other countries that index for inflation.

Your question on indexing, I do not see why that should be so difficult. If the United Kingdom and Australia can do it, I don't understand why we can't do it, either, so, you know, if we were back in 1981 and talking about a depressed economy and depressed growth, I might have a different view, but here we are talking about an economy close to full employment, so I am looking for saving, investment, productivity growth and an increase in potential outputs. If you finance by cutting the inefficient part of the Federal Government, starting on the operations side, you really get a very effective package.

Mr. BLOOMFIELD. Mr. Thomas, first of all, I want to congratulate you for your leadership again on promoting IRAs in this Congress. I might point out that yesterday Jonathan Skinner at the University of Virginia and Glen Hubbard at Columbia released a survey of the literature of the economic impact of IRAs, which I hope you will see soon.

But one of the interesting things they pointed out, which partly responds to your question, is that raising IRA contribution limits would increase long run national capital stock, $4 for every $1 lost in government tax revenue. Their work focuses on distributional tables, the first part of your question, and then also the revenue impact, and this gets into the debate that you have had, and I know the Joint Committee just prepared a pamphlet for the Finance Committee hearing today on do you do dynamic or do you do static revenue estimates. It seems to me that there is some fiscal discipline to starting at least in this round and focusing on traditional static analysis.

Having said that, however, I think we can put capital gains in a special category because of what Dr. Sinai referred to as the unlocking factor. We have on our board of directors of our public policy think tank people like John Shoven and Michael Boskin at Stanford; and Jim Poterba at MIT. We surveyed these mainstream NBER economists, and they are of the opinion that it might be very helpful to have alternative scenarios of the macroeconomic impact of tax policy done carefully because it is controversial. And it seems to me that that would be one way at getting at what Chairman Archer has referred to as accurate revenue estimates because we are concerned about the macroeconomic impact. The ultimate question on distribution is a job lost which could have been created because we tax savings and investment more than our competitors do.

Chairman ARCHER. If the gentleman would suspend, we have about 5 minutes to make this vote, and with apologies to our witnesses, we will recess, vote, and come back right away and continue.

Mr. THOMAS. Mr. Chairman, I might just make a statement that as we sit here and berate the business leaders of America for thinking on a quarterly by-quarterly basis in terms of their investment and then turn around and do exactly the same thing on the Federal Government in terms of the societal needs, I just find it ironic that we don't realize that a 5-year increment is the same as a quarterly basis for business if we are making societal decisions. I will be back.

[Brief Recess.]

Chairman ARCHER. Will our guests please take their seats. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

I would like to ask Mr. Sinai a question. In your testimony, you talked about the locking effect of the capital gains treatment, and the impression I had from you, that I think Mr. Bloomfield corrected, was that the Treasury Department's $60 billion revenue loss over 5 years did not take into consideration the fact that there would be more activity.

Did I misunderstand you?

Mr. SINAI. That is correct. I believe that is true. It does not take into account the effect of the lower capital gains tax on economic activity and saving and all the things I talked about, the macroeconomic effects.

When the economy gets stronger, you get induced revenues coming into the Federal Government on excise taxes, Social Security taxes, and ordinary income.

Mr. MATSUI. We are talking about two different things here. I think what Mr. Bloomfield said, and I don't mean to use him as a way of explaining your situation, but he correctly stated that back in 1990, I guess it was, when President Bush had a capital gains proposal, there was a difference between Treasury and Joint Tax, but both of them took into consideration the fact that it would be more economic activity, it was just a question of how much.

Mr. SINAI. I don't think they did. They just estimated what is called the unlocking effects, and they had two—small numbers, billions of dollars difference, and I do not believe they took into effect the——

Mr. MATSUI. That is not my understanding.

Mr. Bloomfield, because you were right in the middle of that, my understanding is that even—I mean, Joint Tax, they use dynamic scoring in terms of the provision itself, the specific provision itself. They don't use dynamic scoring in terms of the macroeconomic effect but they do use dynamic scoring in terms of the behavioral changes for the tax cut itself. If you could just answer yes or no on that.

Mr. BLOOMFIELD. Yes.

Mr. MATSUI. Dr. Sinai.

Mr. SINAI. What you just said is what I call unlocking, the taxpayer response, the unlocking response.

Mr. MATSUI. It does have an impact, right?

Mr. SINAI. Yes, it does have an impact.

Mr. MATSUI. OK. Then the larger issue is does this have an impact on the overall economy.

Mr. SINAI. Yes.

Mr. MATSUI. Now, let's take the first one first, the behavioral changes for the tax cut itself. Now, Mr. Bloomfield, you mentioned that Treasury had one point of view in 1990 and Joint Tax had another, it was a very small amount, but if you recall the difference was over a 3-year period about $35 billion. In other words, $10 billion difference a year.

I believe the President's proposal at that time had a $22 billion revenue gainer out of it over that period of time, and the Joint Tax had an $11 or $15 billion revenue loser over that period of time.

Now, the real problem I see is that a small almost imperceptible change in assumptions could create a massive problem for us if, in fact, we guessed wrong or we made assumptions that were incorrect.

Now, going back to 1981, because that is, frankly, where my start on this committee occurred, the danger I see is that we can use assumptions that even though they might be only a very small amount off could lead to massive budget deficits, and if you recall, I think you were even sitting in this Chamber here when Dave Stockman and Don Regan and the rest of them said that by 1983 we will have a balanced Federal budget with capital gains, with the investment tax credit, with all of these tax preferences that we gave to the entire private sector, and of course they paid for it, because in 1982 we tightened it up and in 1986 we went all the way the other direction and took all of them away, including the investment tax credit.

I think that is one of the dangers the private sector better be concerned about. They may get it for the next 2 years, but then the next 3 or 4 we may have a total shift in the other direction, but perhaps you can tell me why the assumptions are better in 1995 than they were in 1981.

Mr. BLOOMFIELD. Well, first of all, the most important point is that the unlocking part is so very sensitive to assumptions. I mean, everybody agrees on that.

Under the Bush proposal, as I recall, there was a revenue estimate over 5 years, and it was minus 12 on one side and minus 12 on the other, so whether it would be 35 or 20, it really doesn't make a difference because you raise the valid point you don't want to increase the deficit.

The point I am making, though, since it is so hard for the revenue estimator to come up with something concrete on what the perfect or the most accurate elasticity is, the members of this committee should know that this has nothing to do with supply side economics, this is the estimator's best guess at elasticities. One little change can throw the numbers off, and all I am saying is that you should have before you a range of A to D, and at least know that his number is not any more accurate, assume it is D, than what A would be.

Mr. MATSUI. That is not necessarily true, but let me just end by saying this, I think what you are saying is we should probably be a little cautious at the same time and maybe have a little more spending cuts than we have tax cuts in order to make sure that in case we are wrong we might have a little margin of error, and let me just make one final comment, and all three of you or none of you can comment on this if you like.

Chairman Alan Greenspan testified before the House and Senate Budget Committees recently, and he stated "no model currently can be used to predict macroeconomic developments without substantial ad hoc adjustments." In other words, he is saying basically you can't make macroeconomic predictions on the effect of the economy on tax changes or even changes in many programs like education programs, which some might suggest might be able to raise productivity, thereby increasing the macroeconomic effects of this country.

Do you disagree with Chairman Greenspan, any of you?

Mr. SINAI. Certainly, I disagree with my friend, Alan Greenspan, a professional forecasting colleague before he came to the Federal Reserve. He said that for years. But for years he used himself econometric models in his own forecasting, so I think there is a large body of evidence that says you can have reliable inferences drawn from these models.

Mr. MATSUI. Mr. Chairman, I hate to ask you this, but can I just have one last question?

Chairman ARCHER. How long will the question and the answer be?

Mr. MATSUI. It will be very, very short. I hope it will be very short on their side. It will be very short on mine.

Mr. SINAI. I concur with you that as a business matter you would want to be conservative; you should be aware of static revenue estimates; you should be aware of the dynamic estimates when you include unlocking; you should be aware of the macroeconomic effects; and it is better to make sure you finance it adequately on the spending side and take a conservative approach to it.

Chairman ARCHER. Very quickly, Mr. Matsui.

Mr. MATSUI. Very quickly, Mr. Chairman.

Here is what the problem is, assuming for a minute you are correct that additional investment, by doing capital gains you unlock activity, more investments go because of the capital gains, but what about—here is what the problem is when you use the macroeconomic approach, what about the fact that these investments go to real estate or whatever it is instead of other areas because you are going to be moving capital from one area to another area, to the one that is most generous by way of a tax break, and so, you know, even though it might create activity in one area it may reduce activity in another. This is why the macroeconomic approach, dynamic scoring is so dangerous, frankly.

Mr. SINAI. Yes, the situation we are in now there is still mainly economic incentives for what you mentioned, real estate and capital gains tax reduction would not materially increase the subsidy to that asset class in a similar situation to the past.

I am absolutely convinced and I know the—I think the difficulty with dynamic scoring is the validity of the estimate, who does it and how they are used for political purposes. But I am absolutely convinced it is wrong to think in static terms because that isn't what happens after the fact. What happens after the fact is what happens to the economy, and the revenue results and what goes on in actual behavior, and as far as whether these things actually make a difference in a model or not in a model, you have to talk to businesspeople, financial people, and from the grassroots anecdotal experience find out what they think about this. Over the years, I have tended to be persuaded that something like capital gains actually does have an effect. I notice all our competitors are doing it, lower rates or exemptions, and maybe there is something to be learned from that in terms of capital formation and productivity of countries like Japan.

Chairman ARCHER. The gentleman's time has expired.

I truly regret on these very important issues that we limit ourselves to 5 minutes, but if we didn't, we would never get through all of the members up here.

Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman, and I want to commend you, Mr. Chairman, on your opening remarks. Certainly the goal of our Contract With America and with the majority party on this committee, and I believe a majority of this committee on both sides, is to increase America's savings and be able to maximize our job creation.

And my question to you, Mr. Bloomfield, to get back to something that I think is very important, something that you alluded to somewhat a little bit earlier in testimony, and I want to thank you for your pioneering and research in the debate in this area of capital gains, has to do with these one-time events which I believe is the vast majority of the capital gains sales that take place within my district; I believe in the districts of all of the Members of Congress. It is certainly within my district, that example of the family who has raised their family, the couple are retiring, are selling that home that is larger than what they need to move into a smaller home, and there is capital gains, a one-time event. Or maybe that middle-class farming family in my district that for whatever reason may be, which is their retirement, to sell this property or maybe it would be a small business, a one-time event, and I would like to have you, if you could, maybe relate a little bit more on this comment on how this bunching up phenomenon might make these statistics that would appear to be that those selling capital gains are the wealthy within our society when in reality we are seeing a lot of bunching up, but if you could comment a bit more on that, I would appreciate it.

Mr. BLOOMFIELD. Thank you, Mr. Herger.

One of the things that I would like to draw your attention to, Chairman Archer indicated that we prepared three special reports for this hearing. They are attached to the back of my testimony.

The reason I mention that, if you look at page 2 of the questions and answers on capital gains, the question is: Isn't it true that most of the direct benefits go to the rich? The source of the data is the IRS. The history of this debate, quite frankly, is that opponents of capital gains tax cuts were saying that most of the benefits of capital gains go to people with incomes of $200,000 and above. Those people included capital gains in income, and, therefore, the data assumed that the same person was doing it all the time.

This was a number that the Congressional Budget Office was using. We looked at the CBO analysis and said it distorts it because it assumes that it is the same people who have capital gains every year. To engage in the debate, we said let's exclude capital gains from income, and that is why looking at that number, that assumes that they never repeat, they never have capital gains in their income. We therefore used that data and said that half of all capital gains go to people with a wage income of $50,000 or less. Mr. Cohen is correct, that figure is dollars. What about filers? We said three-fourths of the people who filed tax returns with capital gains reported wage income of less than $50,000.

CBO came back, and they said, well, yeah, but we don't know how many people repeat, and at that point, as we say in our Q and As, a panel analysis for the years 1979–93 by the Joint Committee found that 44 percent of taxpayers reporting gains realized a gain in only 1 out of 5 years. Your farmer, of course, probably doesn't buy and sell his farm every 4 years. He probably does it once in a lifetime. So you can see how the numbers are skewed because that person realizes his savings, eats up his savings once in a lifetime, so this is what the debate is about.

I should add, however, that the debate really shouldn't be focused on middle-class Americans because there are some members of this committee, I know, who would suggest that capital gains only be limited to the middle class, and that has all sorts of distortionary effects because what you are concerned about is not the class source of the capital, you want the capital available to all, and therefore what you really ought to focus on is not the distribution but does capital gains create jobs. We believe lower capital gains creates jobs.

Mr. HERGER. Thank you very much, and again I think it makes sense if you have the family that is making $36,000 a year, has this one-time sale, I guess we could ask how many jobs that person who is middle income, middle class, who is just getting by can create. It really takes those who are the entrepreneurs—those who are doing a bit better are the ones who can afford to create the jobs. I think it just makes a lot of sense, and I think what——

Mr. COHEN. Mr. Herger, they don't pay tax now because the one-time sale of a residence you have got a one-time exclusion, so they wouldn't pay any tax today.

Mr. HERGER. Well, I believe there are those who perhaps—again, we are talking about a middle-class individual who perhaps has a small rental that they have that perhaps they are selling or a piece of property that maybe they have had in the family.

Again, these are not wealthy people. This is middle-class America, and people who have saved, who have accumulated a little something. They are the ones where we have historically with our Tax Codes penalized—and I am happy to see you nodding your head, Mr. Cohen in agreement—these are the ones we penalize. These are the ones that I would like to see and certainly in the Contract With America to stop penalizing those who are attempting to produce and begin rewarding those people and try to again create jobs to increase savings.

Thank you very much.

Mr. SHAW [presiding]. The time of the gentleman has expired.

I would like to ask Mr. Cohen a question. I am somewhat intrigued by the way this thing is going, and I think that sometimes we focus too much on who is getting something rather than trying to focus on what this does for the entire economy.

It takes capital to develop business, create jobs, and all of us will agree that those jobs are better in the private sector; they are more permanent, and that is where we like to see the majority of the jobs in this country. That is what has made this country great.

In following this through, I understood you as saying that you did not believe that capital gains and favorable capital gains treatment would stimulate the economy. Did I misunderstand you?

Mr. COHEN. No, I didn't say that, sir. I just said that the differential in capital gains rate is a religious belief, Mr. Bloomfield and I have discussed this many times, that there will be—if you ask me the question, will there be an unlocking effect if you change the capital gains rate from 28 percent top rate to 20 percent or any other lower rate, yes, there will be more transactions.

I would answer as Mr. Sinai answered a little before this whether that will make sufficient difference to stimulate the economy of the United States, sufficient to pay for the potential costs otherwise, I doubt, but there will be an effect. People will respond to that. People do respond to tax incentives, there is no doubt about that.

Mr. SHAW. Mr. Bloomfield in his testimony said that the income or the revenue received in 1985 from capital gains was more than is being received right now. Is that correct?

Mr. BLOOMFIELD. Yes, Mr. Shaw, the revenue—well, the revenue in 1985 was $26.5 billion. Then it went up in 1986 to $49 billion. In 1987, it was $32.9, $38, $35, $27, $24 billion, and the latest numbers were in 1992, which is $28 billion. That certainly is a drop from what it would have been.

Mr. COHEN. It also had something to do with what the stock market was doing at the time.

Mr. BLOOMFIELD. In that period of time——

Mr. SHAW. I am sure there are other factors, but I think all of the data I have heard would certainly indicate that favorable capital gains treatment is not a revenue loser to the country. I want to explore that further because I think that by the government taking more capital away from the private sector leaves less capital for the private sector to invest.

Mr. COHEN. No, sir, I don't agree with that.

Mr. SHAW. And less money invested in the private sector, means less creation of jobs in the private sector.

Mr. COHEN. I don't necessarily agree with that. The best way that we can increase the stock of capital in the United States is to stop running a deficit. If the United States does not run a deficit, it will not sop up capital and, therefore, there will be more capital left in the economy for the free enterprise system to work on.

Now, that is my belief. Mr. Sinai may have some variance of that, but I think most economists would believe that to the extent that any of this increases the deficit, we are counterproductive.

Mr. BLOOMFIELD. I want to respond to that. Allen, do you want to go first?

Mr. SHAW. Would you two gentlemen respond to that, then I will recognize Mr. Levin.

Mr. SINAI. We are close to full employment now so increasing the deficit significantly would be a mistake. In the early eighties, we were a long way from full employment. Increasing the deficit, if it had only been temporary for 2 or 3 or 4 years, was not a mistake, and so if there is a tax change either because of what it does to the economy or the taxpayer that brings back revenues to the governments, one element in financing it, either that or cutting spending or outlays or the entitlement side on the government side is absolutely essential. I think the budget laws of 1990–93 really make it very difficult not to finance any of the tax cuts you are talking about. I don't detect any mood to overturn that, so it is a choice of which tax cut, can it, does it bring back some revenues, and then how much are the spending cuts or outlay cuts you need to do, to finance that and that is how the overall package looks to me at this time.

I wouldn't be saying the same thing at all times. Deficits are not always bad. If you have a very unemployed economy with a lot of slack, lots of people out of work, you can in that situation by increasing spending, lowering taxes, running bigger deficits, you can actually have a net positive effect.

Mr. BLOOMFIELD. Mr. Shaw, over the long term, though, what we are concerned about is our level of national savings, and obviously after you get through the cyclical aspects of the economy, I agree with Sheldon Cohen that perhaps the biggest thing you could do is reduce the Federal deficit. The difference that Sheldon Cohen and I may have is how you reduce it.

Remember, national saving has three components: Government saving or dissaving; personal saving; and business saving. To the extent to which you reduce the Federal deficit or government dissaving by substantially increasing the tax on personal saving or business saving, you have done the fiscal equivalent of running in place, so I would argue that some of the proposals that people have engaged in the past to reduce the Federal deficit have been counterproductive.

Having said that, that we need to continue to reduce government dissaving in a responsible manner, if you look at the drop in national saving for the last decade or so, we have had a drop in government dissaving because of the deficit. Personal saving has also plummeted, and as Mr. Houghton and I have talked about, business saving has plummeted, so we have got to do things on all three fronts and not just worry about the government deficit.

Mr. SHAW. Thank you, Mr. Bloomfield.

Mr. Levin will inquire.

Mr. LEVIN. Thank you very much.

Dr. Sinai, your estimates for 5 years from the tax provisions are very close to what came from Treasury, as Mr. Stark mentioned, 205 was Treasury and yours are, what, 193? Treasury, when it looks at the period through 2005, comes up with a loss of $725 billion. Do you have any reason to question those estimates?

Mr. SINAI. Yes, but I generally would question any estimates going out that far from anyone, and since we haven't looked at it out to that point, I don't think I could comment one way or the other on the Treasury estimates. Too much happens on budget policy and in the economy between now and then for that to necessarily be reliable.

Mr. LEVIN. Well, but these are just the tax estimates, for example the $500-per-child credit, the neutral cost recovery.

Mr. SINAI. Oh, is that the total package that you are talking about?

Mr. LEVIN. Yes.

Mr. SINAI. Oh, including the tax credit for the $500 per?

Mr. LEVIN. Right.

Mr. SINAI. Then that number doesn't sound out of line. That particular part of it is very expensive, the $500-per-child tax credit.

Mr. LEVIN. And that the neutral cost recovery shifts from a gain to a loss when you look at 10 years.

Mr. COHEN. Yes, it is back-end weighted, so it recovers money early and loses it late.

Mr. LEVIN. So there is a shift from—you have a $19½ billion 5-year gain, Treasury has $18.4 billion. That shifts to a $120 billion loss over 10 years.

Mr. SINAI. I think the figures I used were 5-year estimates from the House of Representatives.

Mr. LEVIN. So you would question that it is likely that the neutral cost recovery proposal would shift to a gain in 5 to a loss over 10?

Mr. SINAI. Without taking account of what it would do to the economy, I probably wouldn't question that. I think, here again, we have another tax policy which would, that particular one, accelerated depreciation, does have—in my studies in the past I have found that to have significant effects on capital spending, and that would have a significant effect on the economy. So, I think when you take account of what might happen in the economy over that period of time as a result of that tax cut, I would argue that the losses estimated are too high, net, over the whole period of time.

Mr. LEVIN. Have you looked at that specifically?

Mr. SINAI. No, we haven't looked at that yet. I have looked——

Mr. LEVIN. You say it would be less cost effective than reducing capital gains?

Mr. SINAI. Yes, I think that is correct. That is based on some unlocking effect out of capital gains, even if it was a conservative one, because no other tax cut has that particular characteristic. Capital gains is always going to be more effective in the "bang for a buck," depending on the economic side of the impact. On the revenue side, it is always going to be more effective because it is going to generate unlocking. Almost all of the studies show this. The issue is whether you get unlocking over all years going out 10 years or whether you just get it for 2 or 3 or 4 years.

Mr. LEVIN. Let me just mention to you, Mark, the staff calculated the data from 1991 in terms of the dollars that result from a capital gains reduction, and I don't understand your figures because the 1991 figures show that 65 percent of the dollars would go to people with incomes of $100,000 or more, so I would appreciate your supplying this soon for the record. I think we need to take a candid look at all these proposals.

I must say, Dr. Sinai, I read your testimony as the most tepid embrace of the proposals in the Contract. You say the tax reductions proposed have much to be commended, but then you say the neutral cost recovery would be less cost effective than reducing the capital gains. The IRA provision, the net effect on overall savings is questionable.

On capital gains you suggest over 5 years, this isn't reflective of lock-in, there would be a loss of $62 billion, and acknowledge that there is a problem of equity, the capital gains provision. I think that is an accurate summation of your testimony.

Mr. SINAI. You have picked certain parts of the testimony. Here is the problem, as I see it down here. If you add up the costs of all the cuts, it is fairly expensive. I think the practical problem is are you going to be able to find the spending side reductions to finance that, and so I am saying that you are probably going to have to pick and choose from what is in there. That was the tone of the testimony, in terms of picking and choosing.

Mr. LEVIN. The red light is on. I will finish.

You say that it is especially important to be careful in a time of fuller employment when there could be an even further dangerous crowding out of savings because of the deficit; isn't that accurate? So you say pick and choose, but be especially careful at this point in our economic recovery; isn't that true?

Mr. SINAI. Yes, that is right; that is correct.

Mr. LEVIN. Thank you.

Mr. BLOOMFIELD. Mr. Levin, may I respond to your comments?

Mr. LEVIN. If the Chairman will indulge. I didn't mean to suggest——

Mr. SHAW. Yes, you may continue.

Mr. BLOOMFIELD. The numbers that I referred to earlier were tax returns not including capital gains as part of income, and the reason I refer to that is because these are not the same people realizing capital gains every year.

I think I have got the same chart in my briefing book that you have, and if you look at capital gains, if you include capital gains in income, what is the distribution, and the answer obviously, it is more skewed toward upper income. But if I look at my 1991 numbers and I look at a total of capital gains of 111,443, I look at capital gains in dollar amounts, 22, 23; 778 out of that goes to people $50,000 or less. If you look at filers, the discussion I had with Mr. Cohen, you still have in 1991 about 60 percent.

Mr. LEVIN. I am not talking about filers.

Mr. BLOOMFIELD. You are talking about dollar amounts.

Mr. LEVIN. We are talking about dollar amounts because you can have millions who receive small amounts and thousands who receive large amounts, and there is no use of obscuring this issue, and I think this committee, without a lot of propaganda, needs to look at a number of issues, growth issues, but also distribution issues, so we will continue the dialog as we have in the past.

Thank you, Mr. Chairman.

[The following was subsequently received:]

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Revised
PRELIMINARY
18-Oct-91

DISTRIBUTIONAL EFFECT OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

[1991 Income Levels]

INCOME CATEGORY (1)	Number of Returns With Tax Change (Thousands)	Percent of Total Returns (2) (Percent)	Average Tax Change (3) (Dollars)	Aggregate Tax Change (Millions of Dollars)	Percent Distribution of Aggregate Tax Change (Percent)
Less than $10,000	118	0.5%	$-105	$-12	0.1%
10,000 - 20,000	325	1.4%	-100	-33	0.3%
20,000 - 30,000	738	4.0%	-155	-114	0.9%
30,000 - 40,000	961	7.0%	-208	-200	1.6%
40,000 - 50,000	1,034	10.2%	-256	-265	2.1%
50,000 - 75,000	1,965	14.3%	-385	-756	5.9%
75,000 - 100,000	981	20.9%	-854	-837	6.6%
100,000 - 200,000	1,184	38.0%	-1,670	-1,977	15.5%
200,000 and Over	684	57.5%	-12,526	-8,567	67.1%
TOTALS	7,991	7.1%	$-1,597	$-12,761	100.0%

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

(1) The income concept used to place tax returns into categories is adjusted gross income (AGI) plus: [1] tax-exempt interest; [2] employer contributions for health plans and life insurance; [3] inside buildup on life insurance; [4] workers' compensation; [5] nontaxable social security benefits; [6] deductible contributions to individual retirement arrangements; [7] the minimum tax preferences; and [8] net losses, in excess of minimum tax preferences, from passive business activities.

(2) Total returns include filing and nonfiling units. Filing units include all taxable and nontaxable returns. Nonfiling units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). However, individuals who are dependents of other taxpayers are excluded.

(3) The tax reduction reported here assumes no change in taxpayer behavior. Thus, this measure understates the tax benefit received by certain taxpayers.

End of Text

Table 1

Distribution of Net Long Term Capital Gains For Returns With Long Term Capital Gains in 1985

(In Percent)

Adjusted Gross Income Class Without Capital Gains	Distribution of Returns With Long Term Gains	Distribution of Long Term Gains	Percentage of Total Returns With Long Term Gains
	(1)	(2)	(3)
Less than $10,000	16.9%	19.7%	5.1%
$10,000 to $19,999	16.5	5.9	6.5
$20,000 to $29,999	15.9	6.1	9.8
$30,000 to $49,999	24.7	12.0	13.6
$50,000 to $99,999	19.7	17.5	24.6
$100,000 to $199,999	4.5	12.6	56.2
$200,000 or more	1.8	26.2	76.1
TOTAL	100.0%	100.0%	9.9%

Department of the Treasury
Office of Tax Analysis

March 14, 1989

Source: 1985 IRS Statistics of Income

Columns: (1) = Percent of returns with long term gains by income class (income net of capital gains)
(2) = Share of total dollar volume of gains by income class (income net of capital gains)
(3) = Percent of total number of returns filed in 1985 with long term capital gains

Mr. SHAW. OK. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you very much.

Mr. Cohen, in the second paragraph of your statement you state that it is interesting to note that we have the finest tax system with the lowest cost of collection of any of the developed countries of the world.

I wonder how you arrive at that. For instance, you are a tax attorney. You obviously get paid for working in the tax area. Is your income calculated as part of that compliance cost?

Mr. COHEN. No, sir, I am talking about governmental cost, and I have gotten that from—I do some consulting work for the United Nations and for several international organizations, and I have studied other systems, looked at their cost of operation.

Mr. HANCOCK. But isn't it also true that the cost of operation, it doesn't consider the fact that the small businessman has to collect the money for Internal Revenue rather than Internal Revenue collecting it?

Mr. COHEN. That is true in Britain and France and Germany and Japan also, sir.

Mr. HANCOCK. Well, isn't it also true that Milton Friedman has said that the biggest mistake he ever made was developing the W–4 withholding, that that started concealing from the individual how much income taxes they paid. It was supposed to have been temporary to finance World War II. Boy, once we got it, we kept it, didn't we?

Mr. COHEN. I have read the Beardsley-Rumel report which is in the IRS somewhere. It was invented in 1942.

Mr. HANCOCK. As a small businessman, I can assure you that for several years my cost of complying with the tax law was much more than the amount of the income tax that I paid, and in fact I tried to make a deal with them, to where I will just send you *x* number of dollars if you won't make me do all this paperwork and that we both would come out a lot better, but they didn't think that would be the proper thing to do.

I would like to get back to Mr. Bloomfield and Mr. Sinai on the problem we have with capital gains. I am very much in favor of capital gains; I don't think there is any question. I get too many telephone calls from individuals that say, look, I am ready to retire, I own two or three pieces of property, I would like to sell, do you think we should wait and see if the Congress is going to pass a capital gains tax reduction. In fact, they have been talking about it ever since we got rid of it in 1986.

The Democrat Party has attached a stigma to capital gains, that only the rich benefit from capital gains, I know that is not true. Anybody that is out in the real world knows that is not true. Would it be feasible to come up with some form of a zero capital gains, say, up to the first $1,000 that would apply to everybody across the board, merely to get rid of this asinine statement that capital gains only benefits the rich? The perception I think is what we have got to get rid of if we are going to be able to get the general public to support it, and get the news media off this topic.

Mr. BLOOMFIELD. Well, Mr. Hancock, you could obviously exempt capital gains up to a certain level. You could say that people in the 15 percent bracket, instead of having their tax reduced to 7.5, you could have an arbitrary number and say zero, so that could be done.

I want to say something about Democrats and capital gains because I think it is very important to recognize that this in the past has not been a partisan issue.

As you may recall, President Kennedy in January 1963 proposed a capital gains tax cut. He talked about it as an engine of economic growth. The history of capital gains tax debates in this Congress—you have people today in the Senate like John Breaux and Joe Lieberman who are for capital gains tax cuts. Tomorrow there will be a breakfast with Democratic Members of Congress who want to reduce capital gains tax cuts. It has not been a partisan issue. It should not be a partisan issue. A capital gains tax cut, as you know, passed a Democratic House of Representatives.

I think, also, if you look at the distribution argument or the fairness argument, the best thing I could bring to bear on this, anecdotally, is a fellow by the name of Joe Dolan, who many of you don't know. Joe Dolan perhaps should be brought to the committee because he could say as much about the fairness of this issue that Mr. Cohen and I talked about.

Who is Joe Dolan? Joe Dolan is a New Jersey painting contractor who was quoted in the Washington Post the day after the election, and he said that "you are looking at a poor man that thinks the capital gains tax cut is the best thing that could happen to this country because that is when the work will come back. People say capital gains is for the rich, but I have never been hired by a poor man."

Mr. SINAI. Congressman Hancock, if I might say, actually Canada has such a system, the first $250,000 is exempt.

The issue of fairness having a—we tax capital too much, as was mentioned by Congressman Crane, too many times as it is, which is part of why savings rates are low and there are enormous distortions in that, so an exemption of zero for lower income families would certainly make sense and could be structured that way. It is a very creative suggestion in terms of dealing with this issue.

To me the criteria are four or five. It is probably a little esoteric and technical, when you use the word "fair" people get very excited about that—I do, too—and the other criteria that I have mentioned have tended to slip by the consciousness of people, and it is just a very emotional rich versus poor issue, that kind of thing.

Mr. HANCOCK. Well in my life prior to the time I came in the U.S. Congress, I was involved in commission selling and getting people started in savings. Anything that we can do to get the young people to start some type of a savings program, it carries on if we get them started early enough. That is what we need to get done. And that is why I would like to consider a zero capital gains rate on the first $1,000 of interest income. I think we ought to look at it real seriously.

Thank you, Mr. Chairman.

Mr. SHAW. The time of the gentleman has expired. Mr. Camp will inquire.

Mr. CAMP. Thank you, Mr. Chairman. I appreciate all the witnesses testifying on our proposals to increase savings and investment.

Mr. Bloomfield, looking through your testimony, it is my understanding that most industrial countries have what we call IRAs or ADS accounts. Is that correct, Canada or Australia?

Mr. BLOOMFIELD. It is correct, yes, sir.

Mr. CAMP. France, United Kingdom. Many of those permit larger contributions than what we have in the United States, is that correct?

Mr. BLOOMFIELD. It is correct. For example, Canada's generous savings plan—in Canada what you can do is you can contribute $3,500 a year to a registered retirement savings plan, and if you do not have an employer pension plan, you can contribute up to $13,500.

Mr. CAMP. So countries, if I understand the tables in the back of your testimony, countries with these IRA-type savings, including Canada's, they have higher savings rates than the United States of America?

Mr. BLOOMFIELD. That is correct.

Mr. CAMP. You note that U.S. personal saving has declined, and you compare the late eighties to the time period between 1960 and 1980, and you also note that net private domestic investment has declined. What do you mean by net private domestic investment?

Mr. BLOOMFIELD. Net private domestic investment is a netting—it refers—for investment you need savings, and investment in the United States can either be financed by our saving or it can also be financed by saving from abroad, and because we did not have sufficient saving in this country we had to rely on savings from abroad in addition to that of the United States, and because there wasn't a total amount of additional savings around, our investment in machinery and equipment, which is what we are particularly concerned about in an economic sense has declined, and as you rightly said, it has declined from 7.4 percent in the sixties and the eighties to less than 3 percent now, and of course the investment level is the key to long-term economic growth.

Mr. CAMP. So savings and investment are directly related?

Mr. BLOOMFIELD. They are related. You cannot have investment unless you have savings, and our savings has been burdened because part of our savings has been used to finance the debt, and that has caused pressure on investment in the United States, and then obviously our ability to continue to bring in savings from abroad is a touchy issue because there is a growing demand for savings in Eastern Europe and around the world.

Mr. CAMP. Is it also fair to say in your testimony that that investment is what is essential to the kind of economic growth to raise real wages for workers across the spectrum, skilled and unskilled?

Mr. BLOOMFIELD. It is critical as Harvard Professor Dale Jorgenson might mention when he appears before the committee on Thursday. The most important determinant of long-term growth is our capital stock, which is a function of the level of investment.

Mr. CAMP. Thank you.

Now, Dr. Sinai, in a table attached to your testimony, you indicate that the IRAs or enhanced IRAs will bring additional revenue to the government in the first 5 years, about $4.7 billion, is that correct?

Mr. SINAI. Yes. Those are estimates done by the House of Representatives, and I have no reason to disagree with them.

Mr. CAMP. All right. But you make the assertion that the IRAs, as outlined in the Contract With America, would not have any net effect on overall saving or that it is a questionable effect on overall saving, yet I don't see any statistics or tables to support that assertion.

Do you have something that you could submit in writing?

Mr. SINAI. We have studied that in the past, and in a study that I did, I did come to the conclusion that there was not a significant effect on the personal savings rate from the IRAs in place at that time. The other research on the subject provides pros and cons.

My opinion is that the research on the subject does not conclusively tell us which way the current proposal would go. I have not done the research on this particular proposal. There are certain incentives to saving having to do with the tax-free drawing for certain kinds of activities, which might make it do better on savings than the past ones. So my answer is I haven't done the research on it to really be able to say.

Mr. CAMP. Would you agree with the tables and the statistics that indicate the countries that have, as I mentioned with Mr. Bloomfield, that have IRA-type accounts have higher savings rates?

Mr. SINAI. You know, they do, but Japan has no IRA or has no provision. They have one of the highest savings rates in the world, so I don't think you can necessarily draw that conclusion based on that two-factor association.

Mr. CAMP. Would you agree, though, that savings and investment are directly related?

Mr. SINAI. Yes, yes. You know, investment decisions can be taken without saving. You then borrow to finance the investment. We borrow internally here in the United States or we borrow externally. Incentives that make businesses invest sometimes are not—they are different than where the saving comes from and you go and you look for the financing. So they are only identical in the definitional sense, not identical all the time in the behavioral sense.

Mr. CAMP. Thank you, Mr. Chairman.

Chairman ARCHER [presiding]. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Let me thank our witnesses for their testimony today. I think all the members of this committee are concerned about the savings ratios of our country and what role the Tax Code plays in encouraging more savings. We are all looking for ways of modifying our Tax Code to encourage additional savings for this Nation to be more competitive.

In that light, reducing the capital gains rate makes sense and I think would have a very positive impact on additional savings. I also think indexing of capital assets could make some sense if we could figure out how to do it administratively and make it simple and not add additional complexity to the code.

But on the neutral cost recovery, I would like to focus your attention on that specific proposal because that does cause me to wonder whether we are talking about a proposal which appears to look good from a textbook point of view, but in the real world is not going to accomplish the results that we all desire.

Let me try to explain. What we are asking investors to do is to invest in an asset under neutral cost recovery, to give up more lucrative depreciation schedules, to give up capital gains favorable treatment because we are going to give them a more economically realistic writeoff of their assets.

Now, Treasury indicates that during the second 5 years, from years 6 through 10, that one proposal will cost the U.S. Treasury $139 billion, that one proposal.

Treasury also has indicated that it will cause shelters where economic decisions will be made based upon the tax consequences rather than based upon what is appropriate economic activity as a result of the 3.5 percent assumption on the economic returns.

Now, if Treasury is right, it is likely that Congress won't let that type of schedule continue in years 6 through 10. There are going to be additional modifications to these provisions and I am wondering whether financial advisors are going to tell their clients to trust the Tax Code and use this neutral cost recovery system.

It may well be that the economic consequences that we are trying to achieve won't become reality because of the skepticism about Congress leaving in place a tax law over 10 years or 15 years or 20 years. We would all like to see more certainty in the tax laws, but if we use an academic exercise such as this neutral cost recovery rather than dealing with the problems of the real world, I am not sure we are doing a service to the people we are trying to help.

Many of us would rather we work on the alternative minimum tax problems than working on this neutral cost recovery, and I am curious as to the views of any who care to express a view on this whether we shouldn't be setting priorities. Capital gains I understand, but as for the neutral cost recovery proposal, isn't there a better way?

Mr. COHEN. You will certainly induce in the small business context a lot more expense. As long as the systems are an elective and you can go into the present system or into the new system, that means that the small businessman has to do the analysis many ways, has to engage lawyers or accountants or somebody who can do that for him and try to give him parameters from which he can make the judgment as to whether he wants the benefits short range, long range, however that would work. So that makes it a much more difficult decision.

The government has to gear up and do it both ways, has to train its people to do it both ways. That is a very expensive process.

Mr. BLOOMFIELD. I think that you should try to fix the AMT. Under NCRS, the fancy word for neutral capital cost recovery, AMT taxpayers are better off. In preparation for this hearing, we asked Arthur Andersen to look at NCRS, the theoretical exercise, and see how NCRS affects the tax treatment of investment in seven assets.

In table 4, we look at computer chips, telephone switching equipment, factory robots, continuous steel casting, let's look at your steel production outside of Baltimore. You will find that in a steel company in your district, perhaps, that NCRS substantially increases the present value for investing in continuous steel casting.

Under the 1981 act we had expensing. If you look at the investment in continuous steel casting after the 1986 act, we got to a present value of 81 percent. With the AMT, you only got a present value of 59 percent. Under NCRS, if you are a regular taxpayer, you are at 95 percent and you can see the relief up to 94 percent present value.

So in terms of running it through a computer through the present value analysis, NCRS helps regular taxpayers and AMT taxpayers.

Mr. CARDIN. Which I would suggest to you, if Treasury is right on these estimates, it is unlikely. What advice are you going to give your clients?

Mr. BLOOMFIELD. The question is, what do you do instead. I agree that you ought to use this opportunity to deal with the AMT. And there are various ways to do that. I would also suggest for non-AMT taxpayers that you might consider phasing in expensing. I would like somebody to explain to me Les Samuel's testimony before this committee and I think exactly how you are going to get a lot of tax sheltering. You are not talking about a lawyer or a doctor investing in a building. We do have passive——

Mr. COHEN. It won't be in a passive situation. It will be within a business. You will skew investment within a business or there will be a temptation to skew toward the most beneficial tax situation and it may affect people's judgment on economics. Hopefully it wouldn't, but people are strange, and they take signals. When you signal them that you want them to do something, businessmen seem to get a herd instinct and they all run to it.

Chairman ARCHER. Perhaps some other panel member might like to pursue Mr. Cardin's inquiry, but Mr. Cardin's time has expired. Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

Mr. Cohen, you just stated that people take signals and you have been saying throughout your testimony that the Tax Code will have an impact on people's behavior, sometimes making them act in ways that are not economically rational.

Those of us who support cuts in capital gains taxes and IRAs and other elements of the Contract With America believe that the Tax Code properly drafted and properly reformed can influence people's behavior in a way that will substantially increase savings and investment, risk taking and job creation. This is a premise that is disagreed with by some of the people who testified before this committee this month.

I asked Congressman Gephardt whether he believed that the Tax Code could encourage savings and investment and he said he didn't think it could. Mr. Block of H&R Block said essentially the same thing.

Do you share our underlying belief that the Tax Code can in fact increase savings and investment?

Mr. COHEN. I think you can skew investment. You see, you can't get more investment unless there is more savings. That is why I keep emphasizing the deficit because I know that a reduction in the deficit will put more capital into the hands of private industry.

Mr. ZIMMER. I agree. But the other provisions of the Tax Code——

Mr. COHEN. I think you skew it, not create it, that is, you can affect where it goes. You don't create new capital. You have to have pain to have new capital. You have to save it. That is the way you get it.

Mr. ZIMMER. Do you have data to support that. You said it was a religious——

Mr. COHEN. It is part of my religion, yes, sir, and also 44 years of tax practice.

Mr. SINAI. I think you could. What I am about to say I am not going to suggest you necessarily do. But you can use the tax system to reduce consumption. You can use the tax system to increase investment and you can have a permanent change.

Suppose we went to a value-added tax with exemptions at lower income levels as our basic tax system. That would reduce consumption and raise savings. That exists in most countries around the world. Suppose at the same time you reduce capital gains taxes or reduce the corporate income tax. I believe that kind of restructuring would reduce consumption, raise saving and raise investment, and that would happen if the economy were fully employed.

When you are at much less than full employment, you can recover a percentage of it all because you have so much room for growth in the economy which will then generate additional saving and spending at the same time. So I think from the macroeconomic point of view, you absolutely can use the tax and spending ability of the Federal Government, the Congress and the Federal Government to alter macroeconomic behavior in very, very significant ways.

Mr. ZIMMER. Mr. Bloomfield.

Mr. BLOOMFIELD. I concur with the economist on the panel.

Mr. ZIMMER. Mr. Cohen, you have spoken approvingly of the 1986 Tax Act and you have said that our efforts would break the faith that was evidenced in that act in the sense that it would restore deductions that were eliminated in exchange for the reduction of the marginal rates.

Isn't it a fact, though, that the marginal rates have been raised significantly since 1986, roughly a 40-percent increase in the top marginal bracket; so isn't that already the mark of a doublecross, so to speak?

Mr. COHEN. I don't want to condone one ill and, therefore, I induce another one. The difficulty with the Tax Code is that one deduction begets another, one credit begets another, one change begets another and then we are all complaining about the complexity of the Internal Revenue Code.

When I came to this room for the first time in 1952 to draft some legislation, which is when I started drafting legislation for the Treasury, the Internal Revenue Code was not as thick as my thumb. Today it is about 5 inches wide. I don't like that. But I can't stop it. When I came to driving a car, it was a stick shift car without air-conditioning. That has changed. I can't go back.

I am saying that you must be careful, and careful is a relative term. Each of you has to apply it in your own judgment about adding things that add complexity in addition to providing benefits, because one begets another. Each one you add will be the marker for the next person that comes along and says, you can do that or you can do this and you can but there is a cost attached to it. There is a cost of administration.

The administration of the Internal Revenue Service has fallen off. IRS used to audit 4.5 percent of returns. Today they audit eight-tenths of 1 percent of returns. We used to have 92 or 93 percent compliance. Today we have 82 or 83 percent compliance. Those things go together.

Mr. ZIMMER. Thank you.

Chairman ARCHER. If I may piggyback on that, we eliminated over 6 million people from the tax rolls in 1986. Those were the people that had the easiest compliance of everybody in the tax paying public. So these comparisons must be made in context as to the percentage of compliance.

But it is Mrs. Kennelly's turn.

Mrs. KENNELLY. Thank you, Mr. Chairman.

And having read Mr. Cohen's statements before and having listened to him, I know that he is very firmly a believer that the most important way we encourage savings is to reduce the deficit. I look at someone like Mr. Bloomfield, who has been marvelous in his years of being in business and capital formation and trying to increase savings and I say to you, I read your testimony and you praise the Contract issue after issue and I understand that, and I love them too, but my problem is paying for them.

I wonder, have you thought at all that maybe we can do some but not all of them. Have you looked at the tax of $500 per child for every family and know what a huge figure that is? Is there any way you could guide us to see how we could do some of these things, not all?

Knowing you all these years, I understand this is exactly where you want us to be, except I know you don't want to have the deficit we do. Is there some way we can approach this by not building up the deficit and at the same time the American public gets some good things that they like?

Mr. BLOOMFIELD. Thank you. What I said in the first paragraph, and I want to reiterate it, is that we applaud Chairman Archer and members of the committee for their commitment, which we share, that this Republican contract needs to be revenue neutral in the aggregate. If it is not, that would be very troublesome for the reasons that you have articulated and that Mr. Cohen has articulated.

If you look at where you cut back if you have to cut back, if you look at the 5-year numbers, and this is not a politically attractive response, 60 percent of the 5-year number, understanding that there are budget gains with the other, 60 percent is the $500 tax credit. If you look at polls, Frank Luntz recently did a poll and he said, which one of these proposals is most popular among the American people? The IRA was the one that was most popular.

I juxtapose those because my concern is savings and investment. Here you have a savings and investment proposal which Mr. Neal and Mr. Thomas and others are supporting which makes economic sense. So from an economic point of view, I have some concerns about overall tax cuts, not commenting directly on the fact that Americans do feel that they are overtaxed.

If you go in other areas, and I understand that there is a religious nature to the capital gains debate, but putting that aside, I think one can make a very strong case that reasonable people can look at that and the revenue cost of capital gains because of unlocking is not that great. Let me just throw that out as a proposition that can be debated.

If you look at other provisions there, I still believe and agree with Larry Summers that IRAs will pay for themselves; in other words, if you look at IRAs, 25 cents of every dollar is what the revenue cost will be. He assumes that if you contribute a dollar, if you get one quarter of new savings coming in, it pays for itself. If you look at NCRS—I have commented on that—I think there are opportunities there to address the AMT.

I would like to go expensing, but you have a revenue problem as you know under 5 years. But my hope is that the committee and the Congress will come up with a revenue neutral aggregate package, which I think is more important than the individual pieces. And if you look at the individual pieces, that is my honest response to how I would cut back.

Mrs. KENNELLY. Am I correct that you probably could not do it in 5 years, but if you do a 10-year figure, you seem to think you could?

Mr. BLOOMFIELD. I don't know what the spending cuts are going to look like.

Mrs. KENNELLY. Good answer, Mark. Nobody does. Thank you very much.

Mr. SINAI. The various tax credits as much as we would like them for American families when you are close to full employment and you may have limited resources to finance tax reductions, tax reductions that stimulate consumption are about the last thing that, from an economic point of view, one would want to do.

Mrs. KENNELLY. Thank you. I think that is the dilemma we are in. We all feel we are paying too much in taxes, we would love to give a tax break, but in the long run, by a tax break, we could end up paying much more than we want to. That is what I am wrestling with.

Out there they think a tax break is a great thing but when you know someone like Mr. Bloomfield who has studied this, you know we can't pay for it at this time under our circumstances with the deficit. We want to give people back more money but, on the other hand, we don't want to increase the deficit. As Mark says, we don't know what the budget cuts are going to be, but we know the money is in Medicare.

You are saying that is a tough one?

Mr. SINAI. I think it is a practical matter to get something done. It is going to be difficult to do all that is in the Contract With America. To try to do it all may lock Washington into a debate about how to finance it that could end up with nothing better done.

In terms of getting something done for some part of the economy and that leads to increased savings and investment, I would encourage you to skinny it down and to make it a more manageable task on the financing side so that Republicans and Democrats and the President can agree rather than ending up having nothing happen from all these very good proposals and the very good debate that has started this year.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

There is no question that this panel supports the effort to increase America's savings and that is what the GOP contract is all about.

Mr. Bloomfield, I would like to ask you a couple of particular questions. Along that line, one element you have in your testimony but is not yet part of the Contract is the spousal IRA. Would you focus on the spousal IRA and how does it relate to equity and to savings?

Mr. BLOOMFIELD. We are very supportive of the spousal IRA. If I could make reference to our IRA special report that is attached, we have a question on that which is on page 3. The basic problem with existing law, as you know, is there is a bias for two wage earners. They get a $4,000 deduction, whereas a family with one wage earner only gets a $2,250 deduction.

So I think it makes a lot of sense from an equity point of view and reviewing the literature, including the report that just came out yesterday, I think IRAs do work and we definitely shouldn't discriminate against a couple with one wage earner.

Ms. DUNN. Thank you.

Mr. Bloomfield, I would also like you to address an issue important to me considering the district I represent, which has many, many small timber properties. What is your thought on what would happen to these owners if they were not exempt on long rotation crops?

Mr. BLOOMFIELD. You are getting into an area which I am not that familiar with and, therefore, if I could—I rarely like to duck questions, but my understanding is tomorrow there will be some witnesses who are able to respond to that. I am just not that familiar with that issue. I am supportive of a broad-based capital gains tax cut and I don't think that one should discriminate between farmers versus people that own securities.

Mr. COHEN. My son-in-law is an economist and deals in timber. He indicates to me, and this is not my area of expertise, that it does take a lot of incentive to hold that long crop 10, 20, sometimes 30 or 40 years, so that he believes incentives need to be produced for those kinds of products.

Ms. DUNN. I certainly share that belief.

Let me ask a general question to the panel. A lot of what we are doing is going to be helpful in terms of increasing savings, and in other ways across the board, but it occurs to me we are doing a patchwork. What is your view of the long-term Tax Code and tax plan that we ought to be working for? For example, is the Armey flat tax something that we ought to be considering?

Mr. BLOOMFIELD. I, in my testimony, started by saying that I think that the GOP contract is an important beginning. If one talks about a beginning, one wants to know what the end is. With regard to Mr. Cohen's comment about using the Tax Code to skew economic behavior, I would like the ending to be a level playingfield between consumption and investment and saving, and our income tax system is biased against savings and investment.

So what does that mean? That means that I share the Chairman's view that we should take a look at fundamental tax reform. There are a variety of proposals out there, as you know. There is the Nunn-Domenici consumed income tax, the universal IRA and expensing on the business side, there is European value-added taxes, there is the Boren-Danforth proposal. In many ways, all those proposals, including the Armey flat tax, have more in common than not.

What they basically have in common is the following. Number one, we are going to eliminate the multiple taxation of savings and investment and we are moving, thereby, in a prosavings and investment tax regime. What I ask you to consider when the Chairman holds hearings on this matter is take all the proposals, don't worry about all the specific details, but focus on the most important one, how do they tax saving and how do they tax investment. In my view, I think our long-term economic future depends on a tax system which taxes savings and investment very little if at all.

Mr. SINAI. My guess is a consensus of economists on this issue would be that the tax system should be designed to increase productivity and potential supply of the economy; that is what ultimately determines the real standard of living of the American people, that is their potential rate of growth. That would favor less consumption, more saving, more investment oriented tax systems.

I wouldn't want to say anything more at this time in terms of the particular kinds of taxation algorithms you might go on to do. But I am sure I speak for the profession in terms of designing it to increase the saving, investment, and potential of the economy.

Mr. COHEN. The tax system is kind of interesting—I have been playing with it for 44 years. The question is whether you go to a gross income tax or a net income tax. If you don't get rid of the income tax, the imposition of a VAT is so much more burdensome. It seems to me, if I were to get rid of the income tax and I might consider one of these alternatives, Mr. Armey's alternative is basically a gross income tax. That is going to hit different people in different ways.

A traveling salesman who uses his car, are you going to give him deductions or not? Are you going to give a deduction for charity? That is going to change the way the United States works. We like housing, we give a housing deduction. All those things will have to be evaluated at the same time. It is not a simple process.

A VAT, if you put in a VAT tomorrow, you have an immediate spike in inflation. That doesn't mean the spike is going to stay there forever but you have to remember that many of the European governments, when they put in a VAT the Belgian Government fell because they had an immediate spike of whatever the rate is, that is how much inflation you get the first day.

It takes a long time for that to work its way through the system if you otherwise relieve certain other taxes. So the political heat will have to be taken by whatever does it, so I think I would go slow and think about it a little bit first.

Chairman ARCHER. The gentlelady's time has expired.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. I guess I will address my remarks to Dr. Sinai since he is the first chief global economist I have ever seen.

Mr. SINAI. Titles don't mean anything, Mr. Rangel.

Mr. RANGEL. Listen, when you got it, flaunt it.

Is there—we don't have the luxury on this committee to vote for part of a tax bill, we do in the process. But when it gets to the floor, unless a part of the reforms are that there is an open rule on a tax bill, generally speaking, it is up or down.

If indeed you were in a position to take a look at the Contract With America and you could not pick what you like, what you didn't like, as economists and in your own minds, at least, you know what is best for America, would you vote for this?

Mr. SINAI. Yes. But then you have the spending side and that has to be taken care of. If we put everything in there that is proposed in the Contract With America on the tax side and on the spending side made the Federal Government more efficient, leaner, more effective and financed it that way and then got into the entitlements that need to be reduced, you would, I think, have a marvelous result.

Mr. RANGEL. Let's talk about the spending sides. Do you have any estimate as an economist, after talking with your colleagues, as to what the long-term spending costs would be if any if we adopted all of the Contract tax provisions?

Mr. SINAI. On a static revenue estimate basis, this isn't very precise, there is a lot more work that has to be done on it. Without cutting into the outyear budget deficit, that is a separate issue, just taking care of this, you are talking about $300 billion of spending and transfer payment reductions over 5 years.

Mr. RANGEL. And the language that you are using, static, that is the commonly accepted description of what the people in the financial market will use in order to determine the——

Mr. SINAI. No, I don't think so. I think for people in the financial markets, dynamic scoring is very controversial.

Mr. RANGEL. What you are talking about——

Mr. SINAI. It is presented in the Contract With America in a static way and the cost has been estimated by various people. We have costed out the static nature of the proposals. From an economic point of view, it is a bit more than what is in the document, $300 billion. Other people might say $200 billion over 5 years. Take some number, take $250 billion, and that is the size of what you would have to think about in terms of spending reductions.

Mr. RANGEL. You agree that no matter what professional experts would say for the majority of what it is, that if it is not accepted by economists generally, then it is not accepted by the marketplace, and it could have an adverse effect if we just went on with some numbers; is that right?

Mr. SINAI. Yes. Truth in estimates is very important for financial markets. They will figure out whether it is credible, whether it makes sense and then the verdict will be registered in the marketplace. Remember when you did deficit reduction, which was very hard to do in the early months of the Clinton administration, the financial markets gave resounding applause to that. They knew it was real.

Mr. RANGEL. No matter what economists they get, we still have to deal with the marketplace in terms of judging what was done. Let me ask you another question because I am for savings, and I think we should have incentives, I think America should be more competitive in how and if we should tax the risks that people make.

You said something which we are saying as Democrats, and I wish more Republicans would say, as exciting as this sounds, we are concerned with how we pay for it no matter what figure we come up with and we think they are taking the right approach. They have to lock in these cuts before we start drafting a bill or something close to that.

Economists never talk about, however, a lack of investment in human skills. They will be the first to agree that if we took a look at our communities with the highest unemployment, the highest number of high school dropouts, the highest level of teenage pregnancy, AIDS, crime, that it costs hundreds of billions of dollars in health and law enforcement, but worse than that, when you put in lost productivity, lost competition and load this into a global economy, if we invested head-on, couldn't we get some dynamic scoring in terms of how much we would save and how much we would gain in the 5- or 10-year period as it relates to the overall economy? Can economists do that?

Mr. SINAI. Yes, they can contribute to that. We are not paying enough, in my view, attention to what you have described as a national problem.

Mr. RANGEL. That is because they want to keep the Federal Government out of local and State government but, my God, when we talk about global competition, we have to talk about the workplace and the labor market and whether or not they, too, can be competitive.

Mr. SINAI. I think the problem which you identify—I am quite sure we all know it is a huge problem and a huge detriment to our family and economic welfare and how our economy performs. Whether you use the Federal Government to do it or some other way through the tax system or through State and local government, that is yet another issue.

Mr. RANGEL. How we do it—it won't be "we" that is doing it. If it is not the Congress, then you have to tell me who.

Mr. SINAI. I am ready to sit on a commission and work with you on the problem.

Mr. RANGEL. I am talking about the national economy, not the local and State, and I am suggesting if I can get your global background to get the interpretation of the cost in dollars and cents of not doing what you think we should be doing, then maybe we can get some static or dynamic scoring for that investment as I am willing to join our chairman and get some dynamic scoring for the reduction in capital gains.

Chairman ARCHER. I thank the gentleman for that comment. With that, his time has expired.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

I would like to explore a remark that Mr. Bloomfield made in his testimony. I understand that you have suggested that investment in equipment is the single most important factor relating to economic growth and development. I know in my district there is certainly a very high correlation between creating jobs that are highly skilled and well paying in businesses that are making a constant effort to invest in new equipment to improve the productivity of their workers and to compete internationally.

Have I accurately portrayed your views Mr. Bloomfield?

Mr. BLOOMFIELD. Yes, you have.

Mr. ENGLISH. Would the other gentlemen care to comment on that viewpoint?

Mr. SINAI. No, I am in agreement.

Mr. COHEN. I don't have disagreement with Mark. We disagree around the edges.

Mr. ENGLISH. Can we explore, then, international comparisons in the cost of capital? I know, Mr. Bloomfield, in your testimony you provided some insights into that. Can you gentlemen generally describe the cost of capital and the treatment of capital in the tax system in our system, in summary, as it compares to our major trade competitors, particularly in manufacturing?

Mr. BLOOMFIELD. Mr. English, what I find most convincing is the table that we had Arthur Andersen prepare for this hearing. There you can look at various pieces of equipment and, if you look at our competitors, whether it be Brazil or Japan or Germany, I think one can make the case from this present value analysis that our capital cost recovery system, including the AMT, is way out of sync.

If you look at OECD countries and you look at where countries get most of their revenue, they rely less on income taxes or they rely more on consumption taxes than we do which, by definition, allow for the immediate expensing of machinery and equipment.

There is a very interesting person you might want to get in touch with, Larry Summers, Under Secretary of the Treasury Department for International Affairs. He and his colleague looked at determinants of economic growth and one of the critical factors was investment in machinery and equipment.

Finally, I would ask that you ask that question of Harvard professor, Dale Jorgenson, who has done that work that I alluded to earlier.

Mr. COHEN. I don't see the cost recovery technique in the United States is that much off from the others. The tax systems vary. For example, the Japanese have a much heavier income tax than we, both on corporations and on individuals. So there is something else going on in the system in terms of the savings rate.

Mr. BLOOMFIELD. I don't think that is true. If you look at corporate tax rates in Japan after the 1986 act——

Mr. COHEN. They are higher. They are not dramatically higher, but they are higher. The individual rates are much higher. Individual rates are around 50 percent.

Mr. BLOOMFIELD. They don't tax capital gains and dividends and all that.

Mr. COHEN. I have not done the study to see how it breaks down for different kinds of income.

Mr. ENGLISH. Would any of you care to comment on whether our tax structure at this time puts us at a competitive disadvantage? Particularly, I would like to gear this to manufacturing, because I have always understood that manufacturing is more sensitive than other areas of the economy to tax changes and level of taxation just because of its nature.

Would you agree with that?

Mr. BLOOMFIELD. I would agree. The big issue is capital costs and that is more than tax policy. If you look at work that Professor John Shoven at Stanford has done, you will find that he attributes our high capital cost, one-third to our tax system, and our tax system does so by heavily taxing investment.

Mr. SINAI. I think once you take out interest rates, that is the major determination of cost of capital. Once you extract from that, I believe we are internationally at a competitive disadvantage. The more incentives which exist, and the more complete a tax system which would help savings and help investment, and any country that employs a VAT, and I am not necessarily for a VAT, but any country that employs a VAT automatically is cutting back the share of consumption in their economy just by that tax method alone, and we are maybe one of two countries that don't use that. We do tax capital many times and have for many years in this country, and that you will not find in many of the countries with whom we compete.

Mr. ENGLISH. I have a few more questions, but we are running late so I want to thank the three of you. I appreciate your coming out and providing your massive expertise.

Mr. SINAI. If I might ask permission to excuse myself. I do have to get a plane.

Chairman ARCHER. We understand, and we are very appreciative of your coming and being with us today. You made a great input to the panel.

Mr. Ensign will inquire.

Mr. ENSIGN. Thank you, Mr. Chairman.

I have a couple of issues to address. First, we have been talking about welfare reform in this committee as well, and one of the comments that Mr. Rangel has made and I share his concern, is where are these jobs in the inner cities going to come from if we are talking about workfare-type programs.

Since we are talking about capital gains taxes, could you address how to encourage jobs in the inner cities, about having a zero capital gains tax in so-called enterprise zones in the United States, to encourage capital investment in those enterprise zones and, therefore, create jobs in the inner cities?

Mr. BLOOMFIELD. First, I think the correct approach to capital gains is a zero capital gains tax rate and some of the enterprise zone proposals do that.

Two, capital gains has a macroeconomic impact in terms of capital costs and it applies to big businesses and small businesses as well.

Third, capital gains taxes are particularly important for startups. The fellow who wants to start a small business, he can't go to a bank or the New York Stock Exchange; he has to go to his friends and his relatives. Obviously, his relative could put money into a bank and get a reasonable rate of return or he can take a risk and invest in a new startup. He will take that risk because his aftertax rate of return is low and, therefore, capital gains has an important microimpact on startups which, hopefully, is where some of these initial jobs will come from.

Mr. COHEN. I suspect that more important than anything the Federal Government does is what is the State and local tax situation, that is real estate taxes and taxes on the property, that is put in there, cost of land, transportation system, police protection, a whole variety of things that need to go into that inner city to make me put a small plant there.

Mr. ENSIGN. I agree, but we don't have control over that so that is why we are addressing the capital gains issue from this level.

Mr. COHEN. That is a marginal effect. He won't go in even if he gets a capital gains break unless he gets these other things.

Mr. ENSIGN. Another issue that you addressed, Mr. Bloomfield, that I agree with, to deal with entrepreneurship and the capital gains and world competitiveness from the United States. You mentioned that lowering the capital gains tax encourages small startups and much of technology breakthrough has come from small companies.

To make the United States more competitive on a world stage, it would seem to me that we want to encourage small startups, from where these technology innovations are going to come from.

Mr. BLOOMFIELD. Congressman, I think what one needs to focus on, in terms of these new technological breakups and job creation, is the whole entrepreneurial process. As you know, the process of starting new businesses involves the entrepreneur. He will be sensitive to capital gains. He will leave the Fortune 500 company and go to a startup because he has the prospect of having a capital gain through stock options. The more formal investors are a second part of the process.

They, of course, are very sensitive to capital gains tax rates. They are going to make a decision whether to put the money in a bank and get a safe rate of return or take a risk on a new business. Venture capital pools, and of course a healthy public market, are important because if you start a technologically sound company, sooner or later they will want to go public.

My point is that all of those are extremely sensitive to capital gains tax cuts. But I know that you are going to have a wonderful panel of entrepreneurs and you should and will address the question to them.

Mr. ENSIGN. My last quick point, Mr. Cohen, and that is we have heard a lot about the economy being at virtually full employment. We are talking about work programs, once again getting back to welfare, and they are saying where are these jobs going to come from, full employment seems like a dichotomy. But we hear capital gains and tax cuts will overstimulate the economy but yet we are concerned that there are not enough jobs for people coming into the work programs from welfare.

Mr. COHEN. The problem is, we are in a technological society and the jobs are for the best trained people, people who are computer literate trained in skills. The folks without the skills are basically locked out. Full employment or not, you can't hire as a computer operator a person who is not literate and can't operate a computer. It is a sociological problem. We do have a class of people who have not received sufficient education to be employed in this kind of an economy.

Mr. ENSIGN. Thank you, Mr. Chairman.

Chairman ARCHER. Dr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Unfortunately—well, first of all, welcome. Our economist slipped away. Senator Henry Jackson used to say he was always looking for a one-armed economist because he couldn't say on the one hand this and on the other hand that.

I think some of us on this committee, in looking at this tax break question, are searching for some way to think about it conceptually that makes some sense. Most of us on this end of the dais voted last year to raise taxes and to cut programs because we were led to believe that deficit reduction was the main thrust of what we ought to do for the economy. So we went through that exercise, painful as it was. Some say we are in the minority in part because of that.

So now we are in a position where I guess the deficit is all taken care of and we should now begin reducing taxes, because I don't know how I am going to go back to my aerospace mechanics and explain to them why we raised taxes last year to deal with the deficit and this year we are now reducing taxes when the deficit is still there, when the national debt is still rising.

How would you explain to the ordinary citizen, because that is our problem—we vote for these tax cuts—what do we say to people to make sense in that kind of tacking back and forth in the ocean of economics?

Mr. COHEN. It is easy to vote for a tax cut. That is the most popular thing in the world. One of the problems that—I was testifying before the committee when the committees back in the seventies started indexing things and I said tax committees would live to regret indexing, although you can't argue with it theoretically. Once you index, the people on this committee only get to vote for tax increases, it is hard to vote for tax decreases. They happen automatically.

I am a deficit hawk. I think that the best thing we could do for the United States is to work at reducing the deficit, certainly in the full employment situation we find ourselves in. If we don't reduce the deficit now, when will we, next time there is a slight dip in production or employment statistics? Of course we won't. We have to do it now and that is why I have been leaning on that element of it.

Mr. MCDERMOTT. Could you, in any way, justify any of these tax reductions on the basis that it is going to be put into savings, in other words, we ought to vote for the ones that can be forced into the savings pool? Would that make sense in terms of economics in the long run?

Mr. BLOOMFIELD. I think the answer to the aerospace worker in your district is I think he would be for proposals that provide for more modern machines and equipment, for better tools. I think also, the fact that Luntz' polls and others indicate the most popular proposal in this Contract is not the $500 credit but it is the IRA proposal. I think he would understand that to the extent to which these things affect savings and investment, and we could have reasonable arguments about whether they do or not, I think that he would be supportive.

Mr. MCDERMOTT. Do you then think that the IRA proposal here is sort of kind of a tax shelter savings account that you can jerk it out at any time, you are going to take off the penalties. The IRAs

I have now, I could get the money, but it is going to cost me a chunk. These ones are kind of loose and they have a certain instability in terms of real savings to them, don't they?

Mr. BLOOMFIELD. Well, there is a question about whether you can withdraw them too quickly. I might have constructed a different IRA proposal. There is a question about whether they shift savings or not, but I still think this IRA proposal will, on balance, create new savings. The fact that your constituent would favor that over a $500 tax credit indicates that he wants to do things that make economic sense.

Mr. COHEN. But it is basically a self-certification and if it is self-certification, that means there is no governor, they can take it out any time they want to.

Mr. BLOOMFIELD. One of the arguments about shifting concerns the fact that the average net assets of an American family is $1,000. So obviously there is not going to be that much shifting. That statistic alone indicates that, sooner or later, people are going to save more through IRAs. It makes economic sense, and your average constituent also doesn't think his savings ought to be taxed. That is a savings proposal.

We can have a debate about your aerospace worker in terms of what proposal would give him more modern machinery and equipment, and that is what I think the committee is about, NCRS or some version of NCRS.

Mr. MCDERMOTT. So on your list, the earlier question you were asked about ranking pieces of this Contract, you would say that the IRA is the number one item that you would go for on the list?

Mr. BLOOMFIELD. No, I don't. I would prioritize them. I think capital gains is in a category by itself because I think the unlocking pays for a lot of it. I don't want this thing passed unless, in the aggregate, it is revenue neutral. There are various IRA proposals. Mr. Neal has his proposal, the President does and others.

As far as NCRS is concerned, I know members of this committee have expressed some concerns and, therefore, there are alternatives there—I wouldn't prioritize one over another.

Chairman ARCHER. The gentleman's time has expired.

Mr. Christensen.

Mr. CHRISTENSEN. I wanted to touch briefly on a couple of points. Early last w^ek, the administration briefed Members of my class on the Mexican bailout or the loan guarantee and during that briefing they handed out materials that talked about some things on the Mexican situation. In there they had one sentence that I liked. This was from the administration. It said "Who benefits?" Well, millions of American middle-class families invest their money in mutual funds.

I tell you, Mr. Bloomfield, for so long I have been hearing this class warfare argument about how a capital gains reduction isn't going to help the middle class, and I am just glad to hear a lot of my colleagues on both sides of the aisle, and this is truly a bipartisan measure, are not taking part in this class warfare bit.

And there have been those that are still out there hollering about it, mainly Les Samuels. We heard him here talking about that. Mr. Samuels stated that there is going to be a sheltering effect. Where in the world is this tax shelter that we are creating? Please explain it to me because I sure don't see it. I have heard it this morning by Mr. Cohen.

Mr. COHEN. It depends on how you define capital gains. As I indicated in my testimony, I don't want to have to brush up on my collapsible corporations again. There are a variety of techniques by which investors can convert what would otherwise be ordinary income into capital gains. If that is allowed, then you will have a great deal of economic activity from lawyers and accountants.

Whether it will be productive economic activity is another question. That goes to how you make the change and how you define it. I don't oppose the true capital gain, but one has to be very careful that you don't allow a variety of activities that don't produce anything and don't do anything for the economy to yield a benefit nevertheless.

Mr. BLOOMFIELD. There is another answer to it. Mr. Cohen pointed out at the beginning of the hearing that our income tax system has a very low cost of administration. I would suggest that it has a very high cost of administration, Mr. Christensen.

If you look at the corporate side, Joel Slemrod at the University of Michigan pointed out for large corporations that it is the most inefficient tax because it costs more to collect and administer it than it does in terms of revenue. If you do what I think you want to do, and that is to have a zero tax on capital gains, if you had a consumption tax, not an income tax—the problem with an income tax is they spend a lot of time trying to figure out what income is versus what capital gains is. They spend a lot of time trying to come up with the ideal depreciation system.

A lot of these technical issues are implicit in an income tax. If you go to a flat tax, you will get rid of a lot of the complexity.

Mr. CHRISTENSEN. Mr. Bloomfield, I want to add to that. I don't want to pick on Mr. Cohen, but you did say you have been involved since around 1952?

Mr. COHEN. I first started drafting legislation for this committee in 1952.

Mr. CHRISTENSEN. You said, I don't like it, but I can't stop it. I guess I would challenge you on that, because I believe you can stop it. You were the Commissioner of the IRS for a long time and that code grew larger and larger.

Mr. COHEN. I administered laws that you folks passed.

Mr. CHRISTENSEN. I think we are heading in the right direction for the first time in a long time. Thank you.

Chairman ARCHER. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I just have a brief question. I know your bladders are being severely tested with the longevity of your being here. My question is this: Is there a better holding period than 1 year? Would, for example, a 2-year period be preferable perhaps or some other holding period?

Mr. COHEN. Back in the twenties when capital gains first came in, they had a graduated holding period. That is—you can get a different result from people by imposing a different standard. That test went, the longer you held it, the lower the rate. I don't necessarily approve of that. I merely recount that as a historian.

Mr. BLOOMFIELD. I can submit, if you would like, a history of the capital gains tax treatment and, as Mr. Cohen did point out, you had a sliding scale in the thirties. Part of the problem with a sliding scale is, how fast do you slide and, as you get close to the new rate, are you locked in? This is implicit in any discussion of capital gains if you don't have a zero capital gains tax rate.

So the answer is, is a sliding scale better than a rate reduction or indexing. It depends how that sliding scale is crafted, how long the slide is and what the rates are. You will also have a debate among different people who are involved in capital gains. Venture capitalists would like a very long holding period to encourage long-term investment, but then you have the mobility argument that we alluded to earlier.

Mr. RAMSTAD. The bottom line for me is, is output growing this economy? I look at the various econometric studies, for example, the one referred to by Dr. Sinai. His bottom line is that if we could create 1.4 million new jobs over a 5-year period, output would stand to increase by $4.4 billion a year. Now, obviously this assumes the rate reduction and indexing and the 1-year holding period.

Would you care to comment how those numbers might change, if at all, given a 2-year holding period?

Mr. BLOOMFIELD. The only thing I would say in response to that is a longer holding period—and you can check with Dr. Sinai on it—a longer holding period would not be good for capital costs in general. That is the fundamental point there.

The other thing I would like to say is that Mr. Archer's capital gains proposal, as a package, it has three parts—it includes corporations, there is no minimum tax—is probably as good a capital gains package as has appeared before this committee and that is no aspersion upon your predecessor, Mr. Frenzel, who played a key role in 1978.

Mr. RAMSTAD. If he were here today, I am sure he would corroborate your testimony. I appreciate eliciting that statement from you. Thank you, gentlemen.

Chairman ARCHER. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Bloomfield, thank you for reinforcing support for the IRA proposal which has been offered by Mr. Thomas and myself. I have offered two versions of the IRA. I offered a more narrow version which would indeed be more difficult for the consumer to get at until retirement. I think in the end that is where some of this debate is going to go.

The expansive IRA that we have offered I think has merit considering some of the issues which confront the American family at this time. But how would you respond to waiving the penalty for withdrawing, that if the vehicle that you are creating is for savings, why would you let people after a prescribed period of time get at it? That is——

Mr. BLOOMFIELD. I think you answered the question. You provided the answer the way you phrased the question. I am troubled with the ease of getting it out. I prefer that it be in there for a while.

Mr. NEAL. Mr. Cohen.

Mr. COHEN. I am worried about the auditability of getting it out. If you have to certify the reason you get it out and that it is on your own self-certification, the government has no way of knowing, except in a very limited audit circumstance whether you really had the education expense, the medical expense or whatever it was. Therefore, you create a problem both ways, that is, the money can evaporate quickly and there is no way of testing whether it ought to be taxed or not.

Mr. NEAL. At the risk of sounding superficial, Mr. Greenspan some years ago in front of the Banking Committee I thought summed it up very nicely when he said that the number one economic problem that America has today is our low national savings rate. Long before this Contract With America was outlined I have been pushing for restoring the traditional advantages of the IRA, and would you comment on that simple assertion that Mr. Greenspan made?

Mr. BLOOMFIELD. Well, I agree, I think he was talking about national savings and obviously there are three components to national savings.

Mr. Cohen and I agree that one of the biggest things is eliminating government dissaving, which is the deficit. I am very concerned that if you eliminate government dissaving by higher taxes on personal saving or business saving you haven't made any progress, so if you eliminate the government deficit by not increasing the burden on other saving, you have made progress, but having said this, if you look at the decline in national saving over the last decade, you have had an increase in government dissaving, you have had a decrease in personal saving, and you have also had a decrease in business saving, so where I might differ with some of my colleagues is that I am worried how you reduce the deficit, and I also think that you can do a lot about personal savings, and, as you know, some witnesses may not agree that IRAs work.

Mr. COHEN. I don't happen to believe IRAs work. My own experience is most of it is transferred, the bulk of it. That isn't to say it doesn't work a tiny bit.

The question is, then, whether the price is worth it. Why savings have fallen so dramatically, I mean, since the time I was in office until now, I don't know. And I don't think anybody else knows, unfortunately. Whether economics has anything to do with it or there are other societal pressures, I think would be an interesting sociological study as well as economic study.

I have seen some of the economic studies. I have not seen any of the sociological studies. It is not fashionable for young people to say I have savings. When I first went to work my brother and I organized an investment club, which still has its money in the account and has been discussed in an economics text of the way it ought to be done. I started when my children first got their first jobs, and we have an investment club, and it invests each month. I did this because I thought that encouraged them as a group, it was a group pressure, if one saves, they all have to save. It has provided a good discipline, but that is not a societal way to do it. I think somebody has to think about that in the broad context of why we changed our behavior in the last 25 years or so.

Mr. BLOOMFIELD. I would suggest that if you compare a country like Singapore with the United States, let's use Singapore many years ago, why were their personal savings rates higher than ours, and I would suggest three factors.

Number one, they made people save. I mean, the government made you as a taxpayer put a certain amount in a postal account. Number two, they had incentives that make our IRA proposals look like pipers, and, number three, they had a big cultural thing. I mean, those people are scared. Having said that, though, you can affect personal saving to a very large extent, it seems to me, through something like the Tax Code and you are not going to make people save in this country, but incentives can work.

Mr. NEAL. Thank you for that timely information.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Cohen, when were you with the Treasury Department or the IRS?

Mr. COHEN. Two different times, from 1952 to 1956 and from 1963 to 1969.

Mr. COLLINS. OK. I think some of the reasons for lack of savings now is because we baby boomers have just gone through about 10 to 15 years of raising dependents, affected by the higher cost of living, college tuition, and so forth.

Mr. COHEN. I had four children in college at one time, sir.

Mr. COLLINS. We didn't have room or the money left in our budget for savings, but that is not part of my question.

A lot has been said about the deficit, but I believe the parameters for the tax reform that we will eventually consider on the floor of the House will actually be determined by the preceding budget reconciliation bill that we will take up first. I think that is going to drive the actual end results of what we do in this committee.

A lot has been said about capital gains and it being used as a tax shelter, but the gain comes only after a person or a business divests itself of a capital investment; is that not true?

Mr. COHEN. Well, sir, that is true, but there are various techniques that lawyers and accountants engage in that have the possibility of converting ordinary income to capital gains. We have those techniques in our arsenal, and unless you stop us, we will have to do it. I mean, that is my job.

Mr. COLLINS. There is really no gain until such time as a person actually divests themselves of the cash—but my point is that once that is done, it enhances the cash flow of the private sector, which leads to taxation.

Mr. COHEN. Well, we are going to differ there, sir. I mean, that is—what you are saying is a truism, but whether it can be abused is what I am saying, and, yes, it can be abused. There are other techniques for abusing it to create what is an artificial capital gain.

Mr. COLLINS. OK. I want to get on to my last question, though.

A lot has been said about how tax policy can actually influence capital investment, and it was mentioned, too, about the aerospace industry. During meetings with General Electric and Boeing, I heard both of them make the same statement about a provision in the Tax Code that had really affected their sales because the air-line industry had been experiencing huge deficits, but was still subject to tax liability, because of their capital investments in aircraft. And the reason they had a tax liability is the alternative minimum tax.

What should we do or should we be looking at the alternative minimum tax? Should we repeal it or should we lower the rate? Or what should we do and why or why not? I would like to hear from both of you.

Mr. BLOOMFIELD. Well, Mr. Collins, as you rightly observed, you get into an alternative minimum tax situation for three reasons: One, you invest and you get more deductions and you don't pay enough taxes. It is crazy, you get an alternative minimum tax because you invest, which is how you get long-term economic growth. You get an alternative minimum tax if your business is in a down cycle and there is a third reason you get into it, so it is a very bad tax in terms of economic policy.

What are the options on the alternative minimum tax?

Well, obviously you can eliminate it, you can speed up the depreciation lives, you can do away with some of the limitations on AMT credits. I mean, there are a variety of specific things you can do.

There will be a panel on NCRS, and I have seen some of the testimony that they will submit, and I would just look at all those. You have got some good witnesses and look at the pros and cons. But I would try to use this opportunity to do something about it, and NCRS, per se, does improve the situation for NCRS AMT taxpayers, as my chart suggests in the testimony.

Mr. COHEN. AMT came into the law in 1969, as I recall it. It came in because there were a variety of large taxpayers, both individuals and corporations, who paid little or no tax while they had allegedly large economic gains. It is a substitute, it is a crude substitute for looking at how deductions and credits, et cetera, ought to apply.

I would prefer if you ask me what is the best way to deal with this. The best way to deal with this is to look at each of the deductions and credits and so forth critically and say do we want to limit them in some way so that they can't apply in an excessive manner rather than coming at this crude measure of this rough and ready AMT. But it came about because the committee at that time couldn't decide on the direct technique and came at it indirectly, so nobody is going to bless it as being a perfect instrument. It is not, it is a very crude instrument.

Mr. COLLINS. I think GE and Boeing both are good examples, though, how this type of taxation has led to fewer jobs on the assembly line.

Thank you, Mr. Chairman. Thank each of you.

Chairman ARCHER. Gentlemen, thank you for I think outstanding input to the committee today, and particularly for your patience in staying here with us for slightly over 3 hours. We appreciate your input.

The committee will recess for about 2 minutes while the next panel takes seats at the witness table.

[Brief Recess.]

Chairman ARCHER. Gentlemen, welcome to the committee. Joseph Lane, who is scheduled to be on the third panel has an imperative need to get away earlier so we have moved him up to this panel, and we are pleased to do that to accommodate you.

At this point inasmuch as you may have to leave before this panel completes its testimony, I would like to recognize you first for your testimony, and you may proceed.

STATEMENT OF JOSEPH F. LANE, MEMBER, GOVERNMENT RELATIONS COMMITTEE, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. LANE. Thank you, Mr. Chairman. Thank you to the members of the committee for providing this opportunity to testify before you today.

My name is Joseph Lane. I am an enrolled agent in private practice in Menlo Park, Calif., and I am appearing here today on behalf of the National Association of Enrolled Agents.

Our 8,900 members are primarily small businesspersons themselves, and they also represent over 4 million individual and small business taxpayers each year in the process of preparing tax returns for them and also representing them before the Internal Revenue Service.

We are happy to be able to comment on some of the specific proposals outlined in H.R. 9, particularly with respect to the capital gains reduction.

We agree and endorse the committee's proposition to reduce that by 50 percent. One area of concern to us is that in the event that this does go through, we would like to see the prior exemption—we are assuming if you have that 50-percent exclusion that it will become a preference item for AMT purposes, and if that is the case, we would like to see the exemption provided for the gain on the sale of the personal residence that was in the prior law also reestablished to exclude that gain from AMT calculation purposes. So if the committee could note that, we would appreciate it.

We agree with the proposal to provide capital loss treatment for the sale on a personal residence. We would like also to see the indexing, we would like to see indexing extended to shareholders of sub-S corporations to the extent that they have basis available.

With respect to the exclusion on the foreign stock corporations, we would like to see the provision that exists in the proposal already to provide an exemption for foreign corporate stock, or ADRs, that are traded on the American exchanges extended to also cover foreign stock mutual funds, which are available to American citizens for investment. As our world economy increasingly diversifies, more and more Americans are allocating a small portion of their investment portfolio to foreign stock mutual funds, and we would like to see that exemption extended to provide for them as well so they can get indexing on those funds that they invest in. For example, T. Rowe Price and Fidelity are the type of firms that offer foreign market funds and we don't see any reason why they should be excluded from the indexing.

With respect to neutral cost recovery, we agree that a major revision to current rules governing depreciation methods ought to be employed, but we think that the driving force ought to be simplification of the tax laws. Mr. Hancock commented before about the difficulty of small businessmen keeping track of this and complying with these regulations. We think this neutral cost recovery proposal could create a situation where the average small businessperson couldn't conceive of how to compute his own depreciation, and we think what you really need to do is lock in on a few simple asset lives and agree not to change the law for a while, and I think you will get a much higher level of compliance and understanding by the taxpayers and the practitioners to boot.

We also have a concern about the way the proposed calculation would work. You actually could be increasing the depreciation basis on an asset that is actually dropping in value. For example, some rental property in California of late would prove that.

On the small business initiatives, we endorse the 179 proposal to increase the annual limitation from $17,500 to $25,000. We think that is clearly in favor of helping businesses become more competitive and aids the small businessperson.

On the home office deductions, we completely support the new definition of a principal place of business that is outlined in your proposal. We think the *Soliman* ruling was a disaster for small business, and we hope that this would overturn that in effect by eliminating the constant interruption by the Internal Revenue Service of the small businesses that operate out of their homes.

The estate tax changes. We also note the proposal to increase it to $750,000. It does benefit owners of small business, farmers, and since that limit has not been changed for almost 15 years, there is probably an inflation increase warranted alone, and the future indexing should allow the estates to be taxed on the true economic value of the estate assets.

So we stand in favor of most of these proposals that you put forth today. We think in terms of small business, the taxpayers that we represent, it clearly would aid them and reduce the burden and simplify some of the rules they have to follow.

[The prepared statement follows:]

TESTIMONY OF JOSEPH F. LANE
NATIONAL ASSOCIATION OF ENROLLED AGENTS

Chairman Bill Archer, Ranking Member Sam Gibbons and Ways and Means Committee members, thank you for the privilege of testifying today. My name is Joseph F. Lane and I am an Enrolled Agent in private practice in Menlo Park, California. I am here to testify on behalf of the National Association of Enrolled Agents (NAEA).

The National Association of Enrolled Agents appreciates the opportunity to comment on this very timely issue which is of great significance to our members, who are themselves primarily small businesses, and their small business clients. Our organization represents more than 8900 Enrolled Agents, specialists in representation of individual and small business taxpayers. Enrolled Agents work with more than four million (4,000,000) individual taxpayers annually.

It is in our role as the voice for our members and for the general taxpaying public that NAEA presents this testimony on the "Contract With America" proposals contained in the Job Creation and Wage Enhancement Act of 1995 (H.R.9).

Our comments on the specific sections of the proposed legislation are presented in an effort to suggest the best means for the Congress and the Administration to administratively implement whatever terms of the bill finally win passage. As we have not received any cost estimates for H.R. 9 as of yet, we are not able to comment on the fiscal impacts which would result from the bill's implementation.

Capital Gains Changes

NAEA supports the initiative that provides for amending Section 1201 to allow for a Capital Gains deduction of 50% We believe passage of this section will aid small businesses in capital formation, encourage investment in our economy and create new jobs for America's citizens. One area of concern to us in evaluating this change is the treatment of this new exclusion when computing the alternative minimum tax. Under prior law, the capital gains exclusion was a preference item for purposes of computing alternative minimum taxable income. If Congress intends to provide for a similar interpretation for this exclusion, we would like to see reestablishment as well of the prior exemption for the gain on sale of the taxpayer's principle residence as an alternative minimum tax preference item.

We also endorse the proposal to permit the capital loss on the sale of the taxpayer's personal residence. This is a change that is long overdue! For many of America's citizens, the home is the one major investment they enjoy. It is only fair that they be afforded the benefit of a capital loss should they suffer such financial reversal. In all, it results in a fairer tax system and this perception of fairness is critical to increasing taxpayer compliance with the tax laws.

We also conceptually support the proposal to index certain assets for purposes of determining gain or loss (Section 1022). We suggest that Congress reconsider the exclusion of Stock in Sub-Chapter S corporations from indexing. A great many small business entities, which provide the vast majority of newly created jobs in our economy, begin their existence as sub-chapter S corporations. While many of these entities elect to convert to regular corporate status once they reach profitability, we do not believe that owners who took the risk to strike out on their own and invest in America by building a business and creating new jobs should be denied the benefit of indexing their original investment in their businesses. This is especially significant if the Congress desires to send the message that entrepreneurship is going to be supported and not discouraged. If a taxpayer can index his investments in existing companies but not his own start-up, it appears to us that the message being communicated is the exact opposite of what we believe is the intent of "Contract with America" initiatives.

A final suggestion for change in this proposed legislation is the exclusion from indexing of stock in foreign corporations. While the bill does provide an exception to foreign corporation stock or ADRs traded on American exchanges, we believe this exception should also be extended to the many foreign stock mutual funds, which are available to American citizens for investment. Many of these foreign funds are offered by U.S. investment management firms such as Fidelity and T. Rowe Price and reflect diversification in their family of funds. As our world economy increasingly diversifies, more and more Americans are allocating a small portion of their investment portfolios to foreign sector mutual funds. We do not believe there should be a "penalty" for making this investment decision.

Neutral Cost Recovery

We agree with Congress that a major revision of current rules governing depreciation methods for business is needed. But, we think the primary factor driving the revision ought to be simplification of the tax laws. Unfortunately, the proposal contained in the Bill (Section 2001) does not meet this critical criterion.

While we do not disagree with the basic premise, that a business ought to be permitted full "economic" expensing of assets employed for productive use, the proposed formula is too cumbersome for business owners to deal with, too complicated for tax preparers to calculate, and too administratively convoluted for the Internal Revenue Service to uniformly enforce. The annual adjustment needed to determine the 3.5% per annum rate of return and the general inflation in the economy since the asset's acquisition date places an unreasonable burden on small business owners to track these assets and the return preparers to properly report them on the tax returns.

In addition, there is potential for significant distortion to reality in the proposed equation. For example, it is possible to have an increase in the general inflation in the economy and an adjustment for the 3.5% rate of return and, at the same time, have the asset drop in market value. California real estate prices in the last few years provide an example. If we applied this proposed formula to a rental home in California we would have increased the depreciable basis of an asset as it drops in value!

A far preferable, and fairer, system for depreciation would be to standardize a few simple asset life rules and agree not to change them for the foreseeable future. This would permit business to plan more cogently, permit tax preparers to accurately calculate depreciation and simplify the verification process for Internal Revenue Service examiners.

Small Business Initiatives

NAEA believes that the proposal to amend Section 179(b) and increase the annual dollar limitation from $17,500 to $25,000 will benefit small business. We believe for most small businesses it will substantially alleviate the cumbersome cost recovery calculations, since it provides an immediate write-off for cash investments made during the year. Businesses which reinvest in their productive capabilities increase their competitiveness. We suggest that the effective date be upon enactment rather than for taxable years beginning after December 31, 1995 as many business owners may defer purchasing needed equipment until 1996 to qualify for the new limit and our small business manufacturing and sales clients would prefer to have their sales increase as soon as possible. Increased sales directly benefit our national economy.

Home Office Deductions

From its inception, the home office deduction has been a contentious issue. Over the years, the Internal Revenue Service has expended a considerable amount of time and resources defining and defending its position in this area at great taxpayer expense. The current law regarding this deduction, resulting from the Supreme Court's *Soliman* decision, has further clouded this issue.

NAEA views the *Soliman* decision's definition of a taxpayer's "principal place of business" as too restrictive and predicts its impact will be devastating on small businesses. This decision has resulted in a definition of "principal place of business" which is extremely difficult to determine and which according to IRS guidance qualifies very few taxpayers for the deduction. "Relative importance" is a very nebulous concept which is very arduous for taxpayers to comprehend. Consequently, the home office deduction remains a contentious issue over which the IRS, taxpayers and their representatives will continue to expend much time and monetary resources.

From a social and economic standpoint the *Soliman* decision is a disaster. More and more businesses are encouraging their workers to work from home and for many fledgling entrepreneurs it's a necessity. Home based workers don't have to commute to work thereby reducing air pollution and conserving our energy resources.

H.R. 9 contains a proposal that would effectively repeal the *Soliman* decision. The home office deduction would be allowed if essential administrative or management functions regularly are carried on in the home office and the taxpayer has no other location for performing such functions. We support this definition of "principal place of business". It better reflects the reality of many legitimate home office situations than the current definition under *Soliman*. In addition, it would be much easier to ascertain compliance than the "relative importance" test. Consequently, fewer conflicts between the IRS and the taxpaying public would arise regarding this issue thereby substantially reducing the time and resources expended resolving differences.

Clearly, the current law regarding the home office deduction leaves much to be desired from the standpoints of fairness, economic policy, social policy and administerability. It is our opinion that legislation along the lines of that contained in H.R. 9 would address the current deficiencies in the law and create a vastly improved home office deduction.

Estate Tax Changes

NAEA notes the proposed changes to Sections 2010 and 2001(c) and agrees that increasing the decedent's exclusion amount to the $750,000 limit does provide additional benefit to the families of small business owners and farmers and other taxpayers. Since this limit has not been changed in almost fifteen years it would appear that an adjustment for inflation alone is warranted. Future indexing of these exclusion amounts should permit annual adjustments to more fairly reflect the true economic value of the estate's assets.

Summary

NAEA appreciates the opportunity to present its views to the Committee on these issues impacting small business taxpayers. We stand committed to further assist the Committee in future deliberations on these issues, and will be happy to provide more specific testimony on key points on the "Contract with America" at future hearings.

Chairman ARCHER. Thank you, Mr. Lane.

Our next witness is William Sinclaire, senior tax counsel for the Chamber of Commerce.

Mr. Sinclaire.

STATEMENT OF WILLIAM T. SINCLAIRE, SENIOR TAX COUNSEL AND DIRECTOR OF TAX POLICY, U.S. CHAMBER OF COMMERCE

Mr. SINCLAIRE. Thank you. Mr. Chairman and members of the committee, good afternoon. I am Bill Sinclaire, senior tax counsel and director of tax policy for the U.S. Chamber of Commerce. The Chamber is the world's largest business federation, representing 215,000 businesses, 3,000 State and local chambers of commerce, 1,200 trade and professional associations, and 72 American chambers of commerce abroad.

The Chamber appreciates this opportunity to testify again before the House Ways and Means Committee. I am here today to focus on some of the tax-related aspects of the Contract.

The Chamber has long advocated the need to reduce the tax on capital gains and fully supports the reform proposal. The current maximum tax rate on long-term capital gains of individuals is near its historic high, and the rate for corporations is the highest ever. The proposal would permit a 50-percent deduction for net long-term capital gains, thereby reducing the effective rate for all taxpayers.

Perhaps the most unfair aspect of the current method of taxing capital gains is that much of the gain is often attributable to inflation. The proposal would eliminate this unfairness by indexing the cost of capital assets for inflation.

Unlike a normal investment, if a taxpayer sells his principal residence at a loss, that loss can never be deducted from income, even if there is a gain from the sale of a subsequent principal residence. The proposal also corrects this anomaly.

A neutral cost recovery system is supported by the Chamber. Businesses are not currently permitted to recover the full economic equivalent of their investments in depreciable business property. Businesses are only allowed to recover the historical costs of their capital expenditures. The proposal would allow depreciation deductions to be increased to approach the economic equivalent of expensing by accounting for inflation and the time value of money.

The Chamber supports the unified estate and gift tax credit increase proposal, and strongly favors reform, simplification, and an overall reduction in the estate and gift tax burden on individuals and the owners of family businesses.

The current unified credit has not been indexed for inflation since it was fully phased in in 1987. Increasing the estate and gift tax exemption to $750,000, with indexing, would be a move in the right direction for the preservation of savings and family businesses. However, the value of a small family business or a family farm can exceed the $750,000 limit, and while the proposal would improve the situation, consideration should be given to having an even higher limit.

The original House version of OBRA 1993 proposed increasing the small business expensing allowance from $10,000 to $25,000.

Nonetheless, the final version only provided for an increase to $17,500. The Chamber supported the original House OBRA version and now supports the proposal to increase the allowance to $25,000. In addition, the Chamber encourages consideration of raising the proposed $25,000 limit to an even higher level.

The Chamber supports the proposal that would allow a home office deduction to an individual if the office is the location where essential administrative or management activities are conducted on a regular basis, and the office is necessary when there is no other place to perform such activities.

The Chamber opposed the OBRA 1993 provision which increased from 50 to 85 percent the portion of Social Security benefits subject to income tax. The Chamber supports the provisions that would repeal that increase.

In conclusion, the Chamber is anxious to work with this committee and the 104th Congress to develop a further agenda to help American businesses grow, create jobs and opportunities, and expand our economy while keeping America strong and competitive in the global marketplace.

To open this dialog, let me just name a few other tax areas that concern the Chamber community—the alternative minimum tax, environmental remediation expenditures, subchapter S reform, and the research and experimentation credit.

The Chamber looks forward to continuing to work with this committee and the entire Congress to achieve this goal.

Mr. Chairman, thank you for the opportunity to share with the Ways and Means Committee the views of the U.S. Chamber of Commerce.

This concludes my oral statement. I would be pleased to address any questions you might have.

[The prepared statement follows:]

STATEMENT
on the
CONTRACT WITH AMERICA
before the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. Chamber of Commerce

by
William T. Sinclaire
January 24, 1995

Mr. Chairman and members of the Committee, good morning. I am William T. Sinclaire, Senior Tax Counsel and Director of Tax Policy for the U.S. Chamber of Commerce. The Chamber is the world's largest business federation, representing 215,000 businesses, 3,000 state and local chambers of commerce, 1,200 trade and professional associations, and 72 American Chambers of Commerce abroad.

The Chamber appreciates this opportunity to testify again before the House Ways and Means Committee. Twelve days ago, Carol L. Ball, Publisher and Chief Executive Officer of Ball Publishing Company, and a member of our Board, testified generally on the *Contract with America*; I am here today to focus on some of the tax-related aspects of the *Contract* -- capital gains, neutral cost recovery, the estate tax credit, small business expensing, the home office deduction, and the taxation of Social Security. I will also address a few other tax concerns of our members that relate to the overall intent of the *Contract* -- the alternative minimum tax, environmental remediation expenditures, Subchapter S reform, and the research and experimentation credit.

CAPITAL GAINS REFORM

The Chamber has long advocated the critical need to reduce the tax on capital gains and fully supports the proposed capital gains provisions included in the *Job Creation and Wage Enhancement Act of 1995* (the "Job Creation Act").

The current maximum tax rate on the net long-term capital gains of individuals is 28 percent and it is 35 percent for corporations. The rate for individuals is near its historic high, and the rate for corporations is the highest ever. This level of capital gains taxation discriminates against capital gains income, discourages venture capital formation, impedes job creation, and hinders America's international competitiveness.

The capital gains reform proposals would permit a 50 percent deduction for net long-term capital gains for all taxpayers. Lower capital gains tax rates would stimulate economic growth, promote technological innovation, and create employment opportunities.

Opponents of a capital gains rate reduction continually renew the myth that a capital gains tax rate reduction would only benefit the wealthy. This is untrue, and the myth must be nullified for it not only harms middle- and lower-income Americans, it also imperils our position in the world economy.

According to Treasury Department estimates, over 55 percent of the individual taxpayers reporting capital gains income in 1993 had adjusted gross incomes of $50,000 or less, and nearly 74 percent had adjusted gross incomes of $75,000 or less. In addition, it must be remembered that these income figures include the capital gains.

Perhaps the most unfair aspect of the current method of taxing capital gains is that much of the gain from the sale of a capital asset is often attributable to inflation. When capital gains are due entirely or in part to inflation, taxing the entire gain serves only to confiscate capital generated from past income -- income that has already been taxed at least once. However, the proposals would eliminate this unfairness by indexing the cost of capital assets for inflation.

Unlike a normal investment, if a taxpayer sells his principal residence at a loss, that loss can never be deducted from income -- even if there is a gain from the sale of a subsequent principal residence. The proposals would correct this anomaly by allowing the loss from a sale of a taxpayer's home to be deductible as any other capital loss.

NEUTRAL COST RECOVERY

A neutral cost recovery system is supported by the Chamber. The Internal Revenue Code (the "Code") currently does not permit businesses to recover the full economic equivalent of an investment in depreciable business property. The Code only allows businesses to recover the historical cost of their capital expenditures for business property and does not take into account inflation and the time value of money.

Inflation and time erode the full recovery of capital expenditures when historical costs are used without future adjustments for inflation and the true cost of money. The Chamber believes capital investments made by a business should be recovered using a depreciation system that provides for the use of the full present value of investments, thereby achieving the economic equivalent of expensing.

The proposal for neutral cost recovery in the Job Creation Act would allow depreciation deductions to be increased to approach the economic equivalent of expensing by accounting for inflation and the time value of money. The Chamber embraces this proposal.

SMALL BUSINESS INCENTIVES

Increase in Unified Estate and Gift Tax Credits

The Chamber supports estate and gift tax reform and strongly favors simplification and an overall reduction in the estate and gift tax burden on individuals and the owners of family businesses. The Chamber supports the unified estate and gift tax credit increase proposal in the Job Creation Act.

The current estate and gift tax system is punitive. It depletes savings and family businesses and effectively punishes capital accumulation and the hard work of a lifetime. Today's estate and gift tax structure can force a successful family business to liquidate or be over-burdened by debt incurred to pay estate taxes.

When a small business owner achieves a moderate level of success, attention must be diverted from the business to the development of an estate plan to help preserve what has been accomplished. With the estate and gift tax laws being very complicated, estate planning and administration can be very expensive. This diverts time, money, and energy that could be devoted to business expansion, economic growth, and job creation.

The current unified credit, which exempts from estate and gift taxes estates under $600,000, has not been indexed for inflation since it was fully phased-in in 1987. Increasing the estate and gift tax exemption from $600,000 to $750,000, with indexing, would be a move in the right direction for the preservation of savings and family businesses. However, even the value of a small family business can exceed the $750,000 limit and, while the proposals would improve the situation, consideration should be given to having an even higher limit.

<u>**Increase in Expense Treatment for Small Businesses**</u>

Increasing the small-business expensing allowance would give businesses a greater incentive to purchase equipment and other tangible property. Assets which are purchased and not immediately expensed must be capitalized and depreciated over a number of years. Not only does this depreciation requirement extend the time period in which a small business can recover the cost of the original investment, it takes into account only an asset's historical cost, and forgets inflation and the time value of the money invested.

Currently, businesses can immediately expense up to $17,500 annually for equipment and certain other capital asset purchases. To the extent a taxpayer's total capital expenditures exceed $200,000 in a particular year, the amount of the deduction is reduced on a dollar-for-dollar basis.

The original House version of the Omnibus Budget Reconciliation Act of 1993 ("OBRA") proposed increasing the expensing allowance from $10,000 to $25,000. Nonetheless, the final version of OBRA provided for an annual limit of $17,500.

The Chamber supported the original House OBRA version, and now supports the proposal in the Job Creation Act to increase the small-business expensing allowance to $25,000. The Chamber believes that increasing the small-business expensing level to at least $25,000 would encourage small- and medium-sized firms to invest more of their resources in productivity-enhancing equipment.

However, in today's marketplace, $25,000 will not purchase very much equipment, even for a small business. Accordingly, the Chamber encourages consideration of raising the proposed $25,000 limit to an even higher level. Increasing the annual amount would spur economic growth and job creation even faster.

<u>**Clarification of Definition of Principal Place of Business**</u>

Until recently, to deduct home office expenses, a taxpayer had to establish that (a) the space in his home used for business purposes was devoted to the "sole and exclusive use" of the office, (b) he had no other office for his business, and (c) his business generated enough income to cover the deductions. Now, a taxpayer must additionally establish that (a) the customers of a home-based business physically visit the home office, and (b) the business revenue must be produced within the home office itself.

The proposal in the Job Creation Act would allow a home office deduction to an individual if his office is the location where essential administrative or management activities are conducted on a regular basis and the office is necessary because he has no other place to perform such activities. In addition, expenses allocable to the storage of product samples would also qualify as home office expenses.

Home offices are becoming more popular because they make sense for businesses, families, and individuals. The narrowing of the home office deduction ignored or tried to roll back fundamental changes taking place in the economy -- more telecommuting, more two-income families with one parent working out of the family home, more elderly and disabled people working at home, more entrepreneurial people who start businesses operating from their homes to minimize costs, and the easing of traditional business hierarchies as more functions are contracted out.

The Chamber supports the proposal in the Job Creation Act that clarifies and expands the availability of the home office deduction.

REPEAL OF INCREASE IN TAX ON SOCIAL SECURITY BENEFITS

The Chamber opposed the OBRA provision which increased from 50 to 85 percent the portion of Social Security benefits subject to income tax. The Chamber believes that reducing the taxes of middle-income retirees is beneficial not only from a social standpoint, but an economic one as well for it would make available additional funds for injection into the economy. Additional spending would help with job creation and the expansion of American businesses.

The Chamber supports the *Senior Citizens' Equity Act* provision that repeals the increase in the portion of Social Security benefits subject to taxation.

BEYOND THE *CONTRACT WITH AMERICA*

Moving from the specific business provisions of the *Contract*, the Chamber is anxious to work with this Committee and the 104th Congress to develop a further agenda to help American businesses grow, create jobs and opportunities, and expand our economy, while keeping America strong and competitive in the global marketplace. This would include the alternative minimum tax, environmental remediation expenditures, Subchapter S reform, and the research and experimentation credit, among others.

THE ALTERNATIVE MINIMUM TAX

The Alternative Minimum Tax (AMT) was enacted in response to well-publicized cases of corporations with substantial income paying no income taxes. Since its enactment, the AMT has become the primary tax system for some of America's basic industries, including the steel, energy, paper, chemicals, mining, transportation, and building sectors.

AMT taxpayers are not allowed many of the investment incentives available to regular taxpayers, including the research and experimentation credit, targeted jobs credits, and other general business credits. Likewise, AMT companies are relegated to one of the worst cost recovery systems for depreciable assets in the industrialized world. The net effect is to discourage participation in some of the most capital-intensive industries and limiting the means for obtaining capital for needed investment in plants and equipment.

Fundamental AMT depreciation reform is critical to any tax policy initiative designed to increase investment since the AMT currently operates to recapture the investment incentive provided by the regular tax. The Chamber believes that there should be no difference between AMT and regular tax depreciation.

The Chamber advocates AMT reform because the incentives to invest in plant and equipment, which create jobs and improve productivity, should be equally available for all assets regardless of the current profitability of a particular company.

ENVIRONMENTAL REMEDIATION EXPENDITURES

The question of how to treat environmental remediation expenditures -- ordinary and necessary business expenses or capital expenditures -- is significant as American businesses are spending billions of dollars in site cleanup, complying with federal mandates, and making energy efficiency improvements.

Last June, the Internal Revenue Service (IRS) issued a revenue ruling recognizing that the costs incurred to clean up land and to treat groundwater contaminated with polychlorinated biphenyls (PCBs)are properly deductible as ordinary and necessary business expenses and do not have to be capitalized. While this ruling is commendable, and it adopted the premise advanced by the Chamber -- environmental cleanup costs are ordinary and necessary business expenses and not capital expenditures -- it is being narrowly construed by the IRS. The issue of whether cleanup costs are current expenses or capital expenditures is not limited to PCB-contaminated soil and groundwater -- it also arises in connection with asbestos, CFCs, lead, leaking storage tanks, and other carcinogens and hazardous materials.

With businesses showing a willingness to spend billions of dollars, the correct tax treatment established by the IRS ruling for PCBs must be extended to its logical conclusion for all contaminants. The Chamber urges finality of the issue with an extension of the IRS ruling that environmental cleanup costs, no matter what the contaminant is, are ordinary and necessary business expenses and not capital expenditures. A resolution of the issue will permit businesses to make an informed decision before committing substantial financial resources.

SUBCHAPTER S REFORM

Subchapter S was first enacted in 1958 to help remove tax considerations from the decisional process of a small businesses owner contemplating incorporation. This has proved quite helpful to small businesses over the years, especially to start-up businesses. Today, over 1.6 million American businesses are S Corporations; however, these businesses are still subject to provisions dating back to the Subchapter S enactment in 1958.

It goes without saying that times have change since 1958. Unfortunately, Subchapter S has not kept pace with the realities of modern business. Business and financial environments are far more complex and the 1950's Subchapter S rules have been outgrown. The Chamber believes Subchapter S needs an overhaul and one should be undertaken.

THE RESEARCH AND EXPERIMENTATION TAX CREDIT

The Research and Experimentation Tax Credit (R&E credit) is due to expire shortly. The Chamber believes it should be made permanent because it will benefit the economy in both the long and short term.

Permanency of the R&E credit is an issue that affects the entire business spectrum. Of all the companies that claimed an R&E credit in 1991, 36 percent had total assets under $1 million. However, the major amount of research and experimentation dollars is spent by large corporations.

The greatest opportunity America has to retain its edge in the world economy is through innovation and technological development and advancement. America must keep pace with its major trading partners and competitors -- Japan and Germany -- by encouraging research and development activities. The growth in research and development spending in Japan is twice that of America, and in Germany, it is half again greater than ours. Both of these countries emphasize research and development through tax incentives.

Research and development cycles can last years, and high levels of research and experimentation must be performed continuously. The R&E credit must be permanent for there to be firm commitments for long-term projects. This, in turn, would benefit all Americans through the creation of jobs, an expansion of the economy, remaining internationally competitive, and raising the quality of life.

The R&E credit is a jobs-creation incentive, and the Chamber believes America needs a permanent R&E credit.

CONCLUSION

Tax policy plays a pivotal role in our economic environment. Sound tax policy can stimulate investment, foster new businesses, spur job growth, and encourage individuals to work harder and save more. However, bad tax policy can retard capital formation, hinder entrepreneurship, reduce job growth, and adversely impact the economy.

The *Contract* will play a key role in reducing the tax burden on Americans, however, sight should not be lost of the steps that need to follow for a comprehensive review of the federal tax laws. Members of this Committee, together with the other members of the 104th Congress, have the opportunity to reduce the tax burden on Americans, create jobs, and a build a vibrant economy. The Chamber looks forward to continuing to work with this Committee and the entire 104th Congress to achieve this goal.

Mr. Chairman, thank you for the opportuinty to share with the Ways and Means Committee the views of the U.S. Chamber of Commerce.. This concludes my statement. I would be pleased to address any questions you might have.

Chairman ARCHER. Thank you, Mr. Sinclaire.

Our next witness, Paul Huard with NAM. Mr. Huard.

STATEMENT OF PAUL R. HUARD, SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman.

Chairman ARCHER. Let me say also at this time that at the conclusion of your testimony we are going to have to run over and answer this quorum call and subsequently vote, so the committee at the conclusion of your testimony will be in recess until we can get back.

Mr. HUARD. Thank you, Mr. Chairman.

It is a pleasure to be here on behalf of our more than 13,000 manufacturing members, 8,000 of whom are smaller firms with fewer than 500 employees. The panel is large and the hour is late so I will submit my full statement for the record and abbreviate my remarks.

I would like to address three areas.

Chairman ARCHER. Without objection, all of your statements will be inserted in full in the record.

Mr. HUARD. Thank you. I would like to limit my comments to the three areas we feel are most critical for the issue of savings and investment, and that is capital gains, individual retirement accounts, and capital cost recovery.

On capital gains, I will say only that we support both the reduction in the capital gains tax rate through the 50-percent exclusion as well as the inflation indexing for cost basis. We strongly urge you to go ahead and do it because it is good for the country, it is going to be good for the economy, and you ought to forget about class warfare and tax policy by distributional tables.

On IRAs, similarly, we support the Contract's provision to improve incentives for IRAs. We basically are supportive of any incentive which will do something to increase our scandalously low personal savings rate. In this particular case, it is also something we think is essential to take pressure off the Social Security system, which, frankly, has questionable long-term viability once the baby boomers start to retire.

Finally, on the issue of capital cost recovery, I think the neutral cost recovery system is a problematical issue. The back-end loading is troublesome, you know. There are a lot of businesses who can't spend present value, they have to rely on cash flow, and also you get the outyear revenue effects.

Those of us that were around when NCRS was put in in 1981 and promptly chiseled away at for the next 7 years have some doubts about the value of putting in something with large outyear revenue losses.

There is also the complexity issue. It might well be better in terms of improving the short-term picture for capital cost recovery to focus on either repealing or substantially curtailing the effect of the AMT and also dealing with the subchapter S issue. As you know, the subchapter S corporation that retains its earnings and reinvests them in capital equipment still has to pay an outrageous rate because you are taxed at the personal rate of the shareholders.

Finally, I would urge you once you complete your work on the Contract to treat it as a beginning and not think that the job is done and to look at the real need for comprehensive overhaul of the tax system that will truly make the system better and more friendly to savings and investment by eliminating all these levels of multiple taxation we have on savings and investment.

In that respect, I think any of the plans that are out there, whether it is Mr. Armey's plan, Senators Nunn and Domenici's plan, the Danforth-Boren plan are well worth looking at. As Mr. Bloomfield on the prior panel pointed out, they have many features in common and one of the most attractive ones is the expensing of capital equipment.

I yield back the balance of my time.

[The prepared statement follows:]

TESTIMONY ON
SELECTED PROVISIONS OF THE "CONTRACT WITH AMERICA"
DEALING WITH SAVINGS AND INVESTMENT

BY PAUL R. HUARD
SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JANUARY 24, 1995

The National Association of Manufacturers (NAM) is a voluntary business association of more than 13,000 firms, large and small, located in every state. Our members range in size from the very large to the more than 8,000 smaller members that have fewer than 500 employees. The NAM's member companies produce more than 80 percent of the nation's manufactured goods.

We appreciate this opportunity to testify on certain tax provisions included in the "Contract With America" intended to encourage greater savings and investment. We remind Committee members that most of our comments are directed to the provisions under Title II of the Contract titled "Job Creation and Wage Enhancement Act" because manufacturing jobs in general provide high wages along with good employee benefits, including health care coverage. We, too, are interested in tax laws that will effectively encourage greater savings and investment which in turn results in the creation of more high wage jobs.

Capital Gains Reform

The NAM supports the two-pronged reform of the tax treatment of capital gains by 1) excluding 50 percent of capital gains from taxable income and 2) indexing for inflation the cost basis of capital assets. This reform, which is applicable to both corporate and individual taxpayers, is long overdue and recognizes that tax proposals which will effectively stimulate economic growth, investment and job creation must be directed to all taxpayers regardless of income and economic status. In the case of indexing, this reform is essential to end the confiscatory taxation of illusory "gains" on long-held assets.

Neutral Cost Recovery System

The legislative goal of the Neutral Cost Recovery System (NCRS) proposal -- to improve the capital cost recovery for productivity-improving assets by providing deductions that are the "economic equivalent" of expensing -- is commendable, as is the congressional recognition that such change is needed. The NAM has long advocated immediate deductibility of capital expenditures; however, the goal of expensing should not be limited only to regular taxpayers. Firms subject to the corporate alternative minimum tax (AMT) will still incur a significant tax penalty on investment under the NCRS because the current law AMT recovery period is, in most cases, about twice as long as the regular tax recovery period. Thus, the economic equivalent of expensing will never be achieved under the NCRS by AMT payers and the current negative effects of the AMT, i.e., disincentives for job creation and investment, will continue.

AMT payers currently rank as having one of the worst capital cost recovery systems among industrialized nations despite repeal of the adjusted current earnings (ACE) depreciation adjustment in 1993. The depth of the AMT problem is widespread and affects many industries, including the manufacturers of chemicals, electronic equipment, energy, metal, paper and steel, as well as transportation-related businesses. In fact, many firms are still paying the AMT today despite an improved economy because of investments they made during the last recession.

Thus, the NAM urges this Committee to consider rectifying current tax code impediments for investment by reforming the corporate alternative minimum tax (AMT). One specific recommendation advanced by President Clinton in February 1993 and advocated by the NAM would be to conform AMT recovery periods with regular tax recovery periods. This recommendation would substantially reduce the cost of capital for AMT payers with basic manufacturing assets and negate the current tax code inequity between companies in the same industry which make the same investments yet have considerably different recovery costs for those similar investments based on the profitability of the companies. Due to the perverse effects of the AMT, the less profitable company often has the higher tax liability.

The NAM would be pleased to work with this Committee in drafting changes to mitigate current tax code penalties on capital investment so as to encourage investment and job creation for both AMT and regular taxpayers. In the long run, of course, the best solution has always been and will continue to be outright repeal of the AMT.

One additional concern about the NCRS worth mentioning is whether the goal of the "economic equivalent of expensing" will actually be achieved given the relative instability of the tax law. If history is any indication, the probabilities for future repeal or limitation of this proposal are high.

I might also note that adding yet another depreciation system will do nothing to alleviate the already byzantine level of complexity faced by business taxpayers making capital investments. Because of this -- and because many businesses survive on their cash flow and would be unable to "spend" the present value of a stream of future NCRS deductions -- an attractive alternative might be a substantial increase in the expensing limit that would be available to businesses of all sizes.

Small Business Provisions

Small businesses have always been an engine of job growth. Two provisions in the "Contract" that would stimulate increased job growth among small businesses are the

1) proposal to increase the amount of capital investment that may be expensed from the current level of $17,500 to $25,000, and 2) the proposal to phase in an increase of the estate and gift tax exemption from the current level of $600,000 to $750,000 with indexation thereafter of the exemption limit. While supporting these proposals, the NAM urges you to address the following problems as part of your approach to dealing with small businesses:

First, no relief is provided from the excessively high rates of tax paid by shareholders of an S-Corporation on income that is retained and reinvested in the business.

Secondly, the relatively low gift tax exemption still leaves the heirs of family businesses with estate tax bills that could force the sale of these family firms. This is one of the primary reasons why it is so difficult and so unusual for family businesses to survive into the second and third generations.

Lastly, the expensing provision is structured in such a way that the increased amount is irrelevant for a small to medium-sized, capital-intensive manufacturer. The expensing provision is reduced dollar-for-dollar when capital expenditures exceed $200,000 -- an absurdly low amount when the cost of even the smallest machine in many industries starts at that level. At many small to medium-sized companies, capital expenditures -- even in a low year -- exceed this $200,000 threshold, so they are never able to take advantage of the expensing provision and it provides no incentive for additional investment. Furthermore, automobiles and trucks may not be expensed under current law. For small businesses of all types, vehicles are critically important and we believe they should fall under the expensing provision.

Expanded IRA Incentives

The NAM has consistently supported changes that would encourage individuals to put more money in individual retirement accounts (IRAs). Additional IRA savings expand the pool of job-creating investment capital and help relieve pressures on the Social Security system, whose long-term viability is extremely questionable.

Tax Reform

The "Contract With America" does not address the issue of overhauling the entire U.S. tax code. Yet compliance and administrative costs associated with our ridiculously complex tax laws exceed tens of billions of dollars annually. And the anti-growth, anti-savings, anti-competitive bias of the present system hurts both domestic and multinational companies in the U.S. The NAM urges that this Committee -- as soon as it completes its work on the Contract -- begin the debate on the long-term goal of tax system overhaul. Major goals of reform of the current tax system should include moderate tax rates at all points in the system; simplicity; stability; elimination of anti-savings biases; proper integration of the corporate and individual tax systems; and greater compatibility with other countries' tax systems so as to improve international competitiveness of U.S.-based taxpayers.

This concludes my prepared testimony, Mr. Chairman. We would be pleased at this time to address any questions you or other members of the Committee might have.

Chairman ARCHER. Thank you, Mr. Huard.

The committee will recess for this vote. We will be back. Thank you for your patience.

[Brief Recess.]

Mr. HERGER [presiding]. The committee will resume, and our speakers will take their seats, please.

Mr. Kleckner.

STATEMENT OF DEAN R. KLECKNER, PRESIDENT, AMERICAN FARM BUREAU FEDERATION

Mr. KLECKNER. Thank you, Mr. Chairman.

I am Dean Kleckner. I am president of the American Farm Bureau Federation. I am a hog, corn, soybean farmer from Rudd, north central Iowa.

I appreciate the opportunity to comment on tax issues important to our 4.4 million member families in the Farm Bureau. The Contract With America contains many good tax reform proposals supported by the Farm Bureau. We urge the committee to view these proposals as a start of a series of tax changes that will improve the economic well-being of our Nation's farmers and ranchers.

In the area of capital gains, the maximum tax rate for real capital gains should be 15 percent, and capital gains should be indexed for inflation. The proposals to provide a 50-percent exclusion and indexing for future price level changes are a substantial improvement over current law.

The capital gains tax creates a disincentive for farmers to upgrade their farming operations because taxes must be paid on assets that are sold to finance improvements. The unimproved farm businesses are less profitable and are uninviting to young farmers contemplating a career in agriculture. Many older farmers and ranchers who would like to transfer assets for retirement income are discouraged by the high taxes on inflationary gains and asset values. This delay in sale of farm assets is a hindrance to young farmers trying to obtain land and equipment necessary to begin a farming operation.

Mr. Chairman, I have had a number of farmers in many States tell me they are just waiting, hopefully for the rate to drop, so they can transfer or sell. They want to do that but they can't afford the current rate.

Many farm commodities like timber, Christmas trees, breeding livestock, dairy cows and equine have extended production cycles and therefore qualify for capital gains tax treatment.

Taxing capital gains on slow maturing commodities, like I mentioned, at ordinary rates reduces the profitability of these operations and fails to compensate producers for risk.

In the estate tax area, that exemption should be increased to $2 million, and indexed for inflation. The $750,000 limit to the adjustment in value that can be made when farmland is valued at its actual use rather than its highest and best use should be eliminated.

The unified tax credit and use value allowance no longer allow many family farm businesses to pass from one generation to the next. When farm business assets must be sold to pay estate taxes, the economic viability of an operation can be destroyed and family members forced to abandon the farm.

Removing the $750,000 limit on the allowable adjustment for use valuation is especially important in areas of the country that are becoming increasingly urban. If this cap cannot be eliminated, it should, at the very least, be increased and indexed for inflation.

Health insurance is an issue that is not addressed in the Contract With America, but it is of extreme importance to farmers, and that is the deductibility of health insurance premiums. A tax deduction for the cost of insurance premiums will go a long way to help farmers and ranchers provide for their own health insurance needs.

There is urgency in reinstating the 25-percent deduction for health insurance premiums paid by the self-employed before farmers file their 1994 tax returns. I might point out, Mr. Chairman, that for a great many farmers that file, that date is March 1, not April 15, so there is even more urgency than you might have thought.

In addition, we think there should be a permanent 100-percent deduction for health insurance premiums paid by the self-employed individuals.

On related farm business tax issues, we support accelerated depreciation; investment depreciation should equal the full value of original investments; and the amount of investment in equipment inventory that can be expensed each year should be increased.

One key item not currently under consideration is the tax treatment of disaster payments. Farmers and ranchers should be able to count income from forced livestock sales and disaster payments in the year that they would normally have occurred so that taxes paid are a fair and true reflection of normal farm income.

In conclusion, but before closing I would like to just mention a tax issue that is threatening the future of agricultural organizations, including the Farm Bureau. The IRS is attempting to tax the dues of Farm Bureau's associate members as unrelated business income. This is misguided, unprecedented, and a reversal of longstanding policy. We urge you to examine the issue and pass correcting legislation.

Mr. Chairman and the committee, thank you for the opportunity to present these ideas.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE HOUSE WAYS AND MEANS COMMITTEE
ON TAX PROVISIONS OF THE "CONTRACT WITH AMERICA"

PRESENTED BY DEAN R. KLECKNER
PRESIDENT OF THE AMERICAN FARM BUREAU FEDERATION
JANUARY 24, 1995

Good day. I am Dean Kleckner, President of the American Farm Bureau Federation and a hog, corn, and soybean farmer from Rudd, Iowa. Farm Bureau is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Our policy is developed by producer members at the county, state and national levels of our organization. I appreciate the opportunity to comment on tax issues important to our member families.

Farm Bureau applauds the efforts of this committee to hold hearings and move forward with tax legislation early in the 104th Congress. Making tax policy more farmer-friendly has been on the top of Farm Bureau's agenda for many years. The "Contract with America" contains many good tax reform proposals which are important to farmers and supported by Farm Bureau. We urge the committee to view these proposals as the start of a series of tax changes that will improve the economic well-being of our nation's farmers and ranchers.

Federal tax policy must give all citizens, including farm and ranch families, more opportunity to keep their own money and create their own personal financial safety net rather than rely on government programs. For farm families to be financially secure, tax policy must create a business climate where well managed farms can produce profits. Then, tax policy must allow farmers to keep more of their income so they can save for future financial security.

Capital Gains

Farm Bureau supports setting the maximum tax rate for real capital gains at 15 percent and indexing capital gains for inflation. Proposals to provide a 50 percent exclusion and indexing for future price level changes are a substantial improvement over current law.

Farming and ranching are extremely capital intensive businesses. Farmers hold land an average of 28.6 years; over this period, the value of total farm real estate in the United States has increased 4.27 times. Much of this increase in value has been due to nothing more than inflation. Farm Bureau believes that taxes on capital gains should be assessed only on the real increases in the value of property and not on nominal gains caused by inflation.

In most instances, the capital gains tax is not a tax on income, but rather a tax on transferring capital from one asset to another. The tax creates a disincentive for farmers to upgrade farm operations because capital gains tax must be paid on land and other farm assets sold to finance improvements. Unimproved farm businesses are less profitable and are uninviting to young farmers contemplating a career in agriculture.

Many older farmers and ranchers who would like to transfer land and other capital property to some other assets for retirement income are prevented by the high taxes on inflationary gains in asset values. This delay in the sale of farm assets is a hindrance to young farmers trying to obtain land and equipment necessary to begin a farming operation.

Many farm commodities, such as timber, Christmas trees, breeding livestock, dairy cows and equine, have extended production cycles. These extended production cycles merit capital gains tax treatment of income when the commodities are marketed. Taxing capital gains on slow-maturing commodities at ordinary rates reduces the profitability of these operations.

Estate Taxes

Farm Bureau supports increasing the estate tax exemption from $600,000 to $2 million and indexing the exemption for inflation. We also support elimination of the $750,000 limit to the adjustment in value that can by made when farmland is valued at its actual use rather than its highest and best use under Section 2032A.

Farming in this country is both a way of life and a business. Perhaps like no other family business, today's farmers and ranchers owe a great deal to the generations who farmed before them. Most learned how to farm from their parents and most started their careers in production agriculture using assets provided by the previous generation.

Estate tax laws that govern the transfer of farm family business assets from one generation to the next were last updated in 1981. Due to gradual inflation and pressure from land development, the current $192,800 unified tax credit and allowance for farm use valuation are no longer sufficient to allow many family farm businesses to pass from one generation to the next. Because more and more farms have assets exceeding the $600,000 exemption, heirs are forced to sell land, equipment and/or buildings to pay estate taxes. When the portion of farm business assets that must be sold is too great, the economic viability of the operation is destroyed and family members are forced to abandon the farm.

Removing the limit on the allowable adjustment for use valuation is especially important in areas of the country that are becoming increasingly urban. Land values for development in these areas are much higher than for agricultural use rendering the $750,000 cap ineffective in preserving farmland. If this cap cannot be eliminated it should, at the very least, be increased and indexed for inflation.

Health Insurance Deduction

An item not addressed in the "Contract with America" but of extreme importance to farmers is the deductibility of health insurance premiums. Farm Bureau must stress the urgency of reinstating the 25 percent deduction for health insurance premiums paid by the self-employed before farmers file their 1994 tax returns. In addition, Farm Bureau supports a permanent 100 percent deduction for health insurance premiums paid by self-employed individuals.

It is difficult to understand why, during the recent debate about health care, this provision to make health insurance more affordable has not been expanded to 100 percent and made permanent. High health insurance costs are particularly troublesome in farming and ranching because it is a hazardous occupation. High risk translates into high insurance premiums, and many farmers are reducing their coverage or dropping it entirely because they cannot afford it. A tax deduction for the cost of insurance premiums will go a long way to help farmers and ranchers provide for their own insurance needs.

Individual Retirement Accounts

Farm Bureau supports changes in individual retirement accounts (IRAs) to expand their use for saving for education, for the purchase and upgrade of primary residences, and for medical illness. Tax changes to reinstate IRAs, to allow non-employed spouses to participate, and to expand the uses for saved funds will be good for farm and ranch families of all ages and are supported by Farm Bureau.

Farm and ranch income can vary greatly from year to year. When farmers and ranchers have good income years, their incomes are heavily taxed as well as their earnings on savings. Proposed changes in IRA rules will allow them to save more money and allow them to retain more of the income from savings. In addition, increasing the variety of uses for savings will give farmers more control of their financial future.

While farmers and ranchers understand the importance of saving for retirement, business capital needs frequently supersede retirement savings. To many farmers, investing in farm assets that can be productive now and sold in the future to finance retirement makes sound business and personal sense.

As mentioned before, farm income can vary greatly from year to year. IRA rules place limits on the amount of funds that can be invested each year. During tough financial years, farmers and ranchers may not have money to invest. Yet in years when they show a profit and could invest, the amount of retirement savings they can shelter from taxes is limited.

Farm Bureau supports allowing farmers and ranchers, in preparation for retirement, to invest proceeds from the sale of property and machinery into a special retirement account on which taxes would be due at the time of withdrawal. Using an IRA, farmers and ranchers could defer capital gains on the sale of qualified farm assets until the money was withdrawn from the special account.

Farm Business Tax Issues

Farm Bureau supports accelerated depreciation. Proposals to increase the value of investment depreciation to equal the full value of original investments and to increase the amount of investment in equipment and inventory that can be expensed each year would help farmers and ranchers and is supported by Farm Bureau. Depreciation rules keep becoming more complex and have less and less relationship to actual investment decisions on farms and ranches. Simplification is long overdue.

One key item not currently under consideration that is very important to farmers is the tax treatment of disaster payments. Farm Bureau supports allowing farmers and ranchers to count income from livestock sales and disaster payments in the year that they would normally have occurred so that taxes paid are fair and a true reflection of normal farm income.

Weather is a factor that can't be controlled or even accurately predicted. In years of natural disasters, farm income from the sale of crops may be severely reduced or even eliminated. Livestock producers who face multiplied feed costs may be forced to sell animals prematurely. In addition to problems caused by reduced income, irregular and unexpected cash flows make farm financial planning very difficult.

Fortunately, the federal government provides disaster assistance to farmers and ranchers in these times of need. Unfortunately, disaster assistance payments and income from forced livestock sales are usually received in a different tax year. Receiving extra income in a single year increases taxes paid by farmers and ranchers who are already financially handicapped by natural disaster and negates the benefits of disaster assistance.

Farm Bureau supports legislation to allow farmers and ranchers who are forced by disaster to sell livestock early to include sale proceeds in the following year if that is when the sale would have normally occurred. In addition, farmers and ranchers should be able to count disaster payments in disaster years regardless of when the aid is actually received if that is when income from crop sales would normally have occurred. The measure should be retroactive to sales after December 31, 1992, to include victims of the 1993 midwestern flood.

There is some precedent for allowing farmers to report disaster payments as income in a year other than the one in which the disaster payments were received. Currently farmers are allowed to report insurance payments, such as hail insurance, in either the year in which the insurance payment was received or the year in which the commodity would have been marketed.

Farm Family Tax Issues

Farm Bureau supports the creation of a per child tax credit and elimination of the marriage penalty. In addition, we believe there should be an increase in the personal exemption for income tax purposes.

The failure of the personal exemption to fully keep up with inflation and with growth of personal incomes has forced a rapid rise in the income tax load for young farmers and ranchers. The increased taxes for married couples has reduced the value of earnings from spouses who work off the farm. While these tax changes would benefit all farmers and ranchers, they would most benefit young farmers and ranchers who are raising families while also trying to build a farm business enterprise.

Conclusion

Before closing, I would like to mention a tax issue threatening the future of agriculture organizations including Farm Bureau. The Internal Revenue Service (IRS) is attempting to tax the dues of Farm Bureau's associate members as unrelated business income. This is misguided, unprecedented, and a reversal of long standing policy.

Tax policy and the resulting rules and regulations are critical to our members. Policies that are fair and equitable promote both the economic well-being of farmers and our nation's food supply. Our tax system must provide incentives for citizens to pay their fair share of their respective tax liabilities and encourage all citizens to create personal financial safety nets. Provision of the "Contract with America" and other ideas discussed in our statement will benefit farmers and ranchers and our economy. We urge you to adopt these changes. We urge the Ways and Means Committee to examine the issue and pass correcting legislation.

Thank for the opportunity to present these ideas today.

Mr. HERGER. Thank you very much for your testimony, Mr. Kleckner.

Mr. Atkinson will testify.

STATEMENT OF TERRY L. ATKINSON, CHAIRMAN, MUNICIPAL SECURITIES DIVISION, PUBLIC SECURITIES ASSOCIATION; AND MANAGING DIRECTOR AND HEAD OF THE MUNICIPAL SECURITIES GROUP, PAINEWEBBER, INC.

Mr. ATKINSON. Thank you, Mr. Chairman, and members of the committee, good afternoon.

I am Terry Atkinson. I am a managing director and head of the municipal securities group at PaineWebber. I am also chairman of the municipal securities division of the Public Securities Association, and it is in that capacity that I appear here today. I am pleased to be here to represent PSA's views on the capital gains provisions of H.R. 9.

I think, as most of you know, PSA represents nearly all banks and securities firms which deal in municipal and other public securities. Consequently, we take an active interest in issues related to capital formation, savings, and investments. We are encouraged by the considerable attention being paid to these issues of late, and we commend this committee for calling the series of hearings.

I would like to focus this afternoon on PSA's views on two of the capital gains provisions contained in title I of H.R. 9, and also on the need to restore capital gains tax treatment for municipal bonds purchased at a market discount.

Savings and investment are essential for the sustained gains in productivity, standards of living, and economic growth. PSA generally supports responsible proposals to encourage capital investment and savings. In that regard, we fully support the two provisions of H.R. 9 which would effectively reduce the tax rate on such gains and would allow taxpayers to index capital gains for inflation. These two provisions would create powerful incentives for families to save and invest. The result would be a stronger, more productive, and more competitive economy.

I would now like to turn to an issue also closely linked to savings and investment: The tax treatment of market discount on tax-exempt municipal securities. Market discount occurs when bonds trade at prices below face value, usually as a result of increasing interest rates. This is admittedly a complex and arcane issue. The provision in OBRA 1993 which amended the treatment of municipal market discount from capital gain to ordinary income has resulted in a less stable, less liquid market. It has also resulted in tax rules which are complicated and difficult to apply, even for professional tax practitioners.

Let me outline a few of the effects the provisions have had on the municipal market.

First, the liquidity of the market has been negatively affected. Some investors, especially mutual funds and bank common trust funds, have refused to buy market discount bonds altogether. This problem is especially acute in today's market where, as a result of higher interest rates, there are large numbers of discounted bonds being traded.

Second, pricing of discounted bonds has become more volatile, inefficient, and misunderstood. Peculiar interactions between discounted bonds and bonds trading at or above face value occur regularly. As a result, sellers get significantly lower prices for their investments than they should, and buyers face prices that are difficult to understand and evaluate.

Third, higher secondary municipal market yields will ultimately lead to higher costs for States and localities in issuing securities in the primary market to pay for much-needed public infrastructure investment. The ability of States and localities to raise capital for public investment depends on a stable and liquid secondary market for their securities. Since the adoption of new market discount rules, the market has become more volatile and less liquid.

Last, the new rules are not accompanied by any significant economic gain for the Federal Government. Whatever revenue is realized by the Treasury will not come until far into the future. The market effects, however, are immediate.

In short, because they negatively affect municipal securities issuers and investors, the new rules for municipal market discount are a disincentive to savings and investment. They offer little economic benefit and do not effectively address any public policy concerns.

We strongly support the capital gains provisions in H.R. 9. However, we also urge the committee to address a tax provision that is harmful to savings and investment: Restore capital gains treatment for market discount on municipal bonds. Congressman Cardin introduced legislation in the last Congress designed to address this issue, and we urge the adoption of a similar provision as an amendment to H.R. 9.

Thank you for the opportunity to present our views. I look forward to answering your questions.

[The prepared statement follows:]

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PSA

Statement of
Terry L. Atkinson, Chairman
Municipal Securities Division
Public Securities Association

before the
House Committee on Ways and Means

January 24, 1995

Thank you, Chairman Archer, and good morning. I am Terry Atkinson, and I am a managing director and manager of the municipal securities group at PaineWebber, Inc. I am also Chairman of the Municipal Securities Division of the Public Securities Association (PSA). I am pleased to be here this morning to present PSA's views on the capital gains provisions of H.R. 9, the Job Creation and Wage Enhancement Act of 1995.

PSA represents banks and securities firms which deal in municipal securities, U.S. government and federal agency securities, mortgage- and other asset-backed securities and money market instruments. Consequently, we take an active interest in issues related to capital formation, savings and investment. We are encouraged by the considerable attention being paid to these issues of late, and we commend Chairman Archer for calling this series of hearings.

My statement this morning will focus on PSA's views on two of the capital gains provisions contained in the Contract with America and in Title I of H.R. 9, a 50-percent capital gains deduction and a provision to index the application of the tax on capital gains to the inflation rate. I would also like to discuss the need to restore capital gains tax treatment for municipal bonds purchased at a market discount.

The Public Securities Markets and Capital Gains

One of the most unique aspects of the markets represented by PSA is that they exist primarily to serve public policy goals. The municipal bond market exists to provide financing for state and local investment in infrastructure and other productive assets. The government and federal agency securities markets provide capital and liquidity for securities issued by the U.S. Treasury and U.S. government agencies. These markets reduce the costs to American taxpayers of funding the federal budget deficit and also finance other government investment. The mortgage-backed securities market helps provide financing for home ownership. By bringing together investors and public sector borrowers, these markets together provide hundreds of billions of dollars in financing each year for investment which is vital to the nation's continued economic strength.

Savings and investment are essential for sustained gains in productivity, standards of living and economic growth. PSA generally supports responsible proposals to encourage capital investment and savings. In that regard, we fully support the two provisions in H.R. 9 which would provide for a 50-percent deduction of realized capital gains — thereby reducing the effective tax rate for such gains — and would allow taxpayers to account for inflation in calculating capital gains subject to taxation (Sections 1001 and 1002 of the bill). Reducing the tax rate on capital gains and indexing gains for inflation would create powerful incentives for families to save and invest. The result would be a stronger, more productive and more competitive economy.

Capital Gains and Market Discount

An issue closely related to capital gains reform involves the taxation of securities purchased on the secondary market at a discount, securities aptly referred to as "market discount bonds." The budget reconciliation legislation enacted into law in 1993 (OBRA '93) contained a provision that amended the tax treatment of municipal securities purchased at a market discount. The law causes financial gain from the sale of these instruments to be taxed as ordinary income rather than as capital gain. The new market discount rules have had a harmful effect on secondary market liquidity for municipal securities, are overly complex and burdensome to apply, and will eventually increase borrowing costs for state and local government issuers of municipal bonds. Since the principal goal of H.R. 9 is to increase investment by decreasing the taxation of capital gains, restoring the lower, pre-1993 tax rates on gains from the sale of market discount bonds would be entirely consistent with the bill. Such a change would decrease the tax burden on an important investment tool and restore lost market liquidity.

The consequences of the change in tax treatment of market discount to trading and pricing of municipal securities have been enormous. The tax principles involved are technical and complex. The issues surrounding the new treatment of market discount are often misunderstood by professional tax analysts and practitioners, to say nothing of individual investors.

Market Discount and Liquidity

Market discount exists when a bond is purchased in the secondary market at a price below par, or face value. Market discount is the difference between the purchase price of a bond and its stated redemption price at maturity.[1] In most cases, market discount exists because yields have increased since bonds were originally issued. For fixed income securities like municipal bonds, when yields rise, prices fall, resulting in bonds that trade below face value. A *de minimis* rule exists so that if the amount of market discount is small — an amount less than 0.25 percent of the face value of a bond times the number of years between the bond's acquisition and its maturity — the discount is taxed as under previous law.

Before the enactment of OBRA '93, accreted market discount on municipal bonds was taxed as capital gain at the time the bond was sold, redeemed or otherwise disposed of. Under the new law, accreted market discount is still taxed at the time a bond is sold or redeemed. However, accreted market discount is now being taxed as ordinary income, not as a capital gain. The pre-OBRA '93 exemption from the market discount rules for municipal securities was important for one principal reason. Because the interest earned on municipal securities is generally exempt from federal taxation, many municipal bond investors avoid bonds with an element of ordinary, taxable income. The exemption from market discount rules for municipal securities tended to broaden the investor base for state and local bonds, thereby maintaining the liquidity of the market.

For example, suppose an investor buys a tax-exempt bond in the secondary market at a price of 90[2] with ten years left until maturity. (Assume the bond was originally issued at par, or face value — a price of 100.) Five years later, he or she sells the bond at a price of 95. The investor must treat the five-point gain as ordinary income in the year the bond is sold. (Total market discount at the time the bond is purchased is ten points, which must be accreted on a straight-line basis over the ten years until maturity. After five years, accreted market discount totals five points.) Suppose, under the same circumstances, that the investor holds the bond to maturity. Ten points (the entire amount of market discount) are taxed as ordinary income in the year the bond is redeemed.

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[1] In the case of a bond sold at original issue discount, such as a zero-coupon bond, market discount is the difference between a bond's adjusted issue price and its stated redemption price.

[2] Municipal bond prices are quoted here in points, or percentage of face value. A $1,000 bond trading at a price of 90 sells for $900.

These examples highlight the simplest scenarios. In reality, most calculations of market discount are much more complex. If, for example, an investor buys a bond with original issue discount (OID) and then sells the bond prior to maturity, he or she could realize income as tax-exempt interest, tax-exempt OID, capital gain or loss, and market discount taxable as ordinary income, all from a single transaction. The calculations required to distinguish from among these four types of income are complicated and burdensome. The chances of anyone — even professional tax practitioners — correctly calculating their tax liability in such a circumstance are minimal. Although it surely was not the intent of the drafters, the market discount provisions contained in OBRA '93 have resulted in rules that are extremely difficult, and for some nearly impossible, to comply with. The new tax treatment for market discount has also resulted in unpredictable and volatile pricing for discounted municipal bonds.

Market Discount and Volatility

Since the new market discount rules took effect, a two-tier secondary market has existed for municipal securities. One tier consists of bonds where market discount is treated as ordinary income (market discount bonds) and the other of securities where there is no discount or where *de minimis* discount is taxed as capital gain. The interaction between these two segments of the municipal market regularly results in inconsistent, inefficient and misunderstood pricing of discounted municipal bonds on the secondary market. Indeed, discounted municipal bonds can trade at yields of 20 basis points (0.2 percentage point) or more above comparable municipal securities selling at or above face value. In mid-1993, market interest rates were at historical lows. Very few municipal bonds were traded at a discount, and the effects of the new tax treatment were not widely felt. Although PSA strenuously opposed the new treatment of market discount during deliberations over OBRA '93, as a result of market conditions at the time, the municipal finance community failed to focus on the problems generated by the provision. The effects of the change in tax status have been magnified by a drastically different bond market which has emerged over the past year. As a result of changing economic expectations among investors and actions taken by the Federal Reserve, interest rates have increased considerably since the enactment of OBRA '93, resulting in many more bonds trading at discounts. The market effects of the provision are now severe.

As a result of their new tax status, the market for discounted municipal bonds has become significantly less liquid — there are fewer investors, and discounted bonds offered for sale are priced less aggressively. Many tax-exempt bond mutual funds and bank common trust funds have stopped buying discounted bonds altogether, citing specific restrictions against earning ordinary, taxable income or an unwillingness to report taxable income to fund investors. Other investors, especially retail investors, avoid market discount bonds because of the complexity of calculating the amount of discount subject to taxation. In practice, market discount municipal bonds are priced based on an after-tax yield assuming the investor is in the highest marginal tax bracket of 39.6 percent. However, investors do not actually incur a tax liability from market discount until bonds are redeemed, and this often occurs when the bonds mature many years into the future. In many cases, especially when bonds serve as retirement savings, the investor by then is in a lower marginal tax bracket.

In addition, under the new rule, investors can no longer offset gains attributable to market discount bonds with capital losses on other investments. The worst circumstance for a tax-exempt mutual fund, for example, would occur in a year where the market performed poorly and the fund's overall performance was negative. In previous years, any market discount realized by the fund during the year would be offset by capital losses. However, under current law, that fund's shareholders may be subject to ordinary income tax on market discount in a year when the fund actually had an overall negative return. Such a circumstance has a chilling effect on investors in tax-exempt funds, and tends to discourage investment in municipal bonds.

The effects of the new tax treatment for market discount were exacerbated by market conditions in 1994. Historically steep increases in interest rates caused bond prices to fall precipitously throughout the year. As prices of municipal securities fell below face value, secondary market investors began demanding even higher yields to compensate them for the higher rate of taxation of market discount, causing prices to fall even further. Falling bond prices caused many mutual fund investors to exit the market, forcing funds to sell bonds at discounts in order to "cash out" shareholders. Selling by funds resulted in even more market discount bonds in the market for which the few buyers that remained demanded even higher yields to compensate for the new tax treatment. The market discount rules helped perpetuate market conditions where sellers got significantly lower prices for their investments than they should have, and where buyers faced prices that were difficult to understand and evaluate.

These higher secondary market yields now demanded by buyers of market discount bonds will ultimately lead to higher costs for states and localities in issuing securities in the primary market to pay for much-needed public infrastructure investment. The ability of states and localities to raise capital for public investment depends on a stable and liquid secondary market for their securities. Since the adoption of new market discount rules for municipal securities, the market has become more volatile and less liquid.

The added capital costs for states and localities that will result from the new market discount rules are not accompanied by economic gain for the federal government. Although the new policy was designed to prevent high-income individuals from converting ordinary income into capital gains, no evidence exists that such behavior has ever, or would ever, be widespread in the municipal secondary market. Therefore, the savings to the federal treasury are negligible. Whatever revenue is generated will not be realized until far into the future when market discount bonds are sold or redeemed. The negative effects on the marketplace, however, are immediate.

Summary

The tests of a well-constructed tax law are that it is equitable and easy to apply, that it achieves a policy goal and that its benefits exceed its costs. PSA believes that the capital gains provisions contained in H.R. 9 meet these tests. The goal of the capital gains provisions in H.R. 9 is to encourage savings and investment in order to strengthen the economy. PSA believes that savings and investment are vital to growth, productivity and our standard of living, and for this reason, we support the provisions of H.R. 9 providing for a 50-percent deduction of capital gains and indexing gains for inflation.

The new market discount rules for municipal securities meet none of the tests of a good tax law. It is not equitable: sellers of municipal securities are unnecessarily hurt by inefficient pricing. It is not easy to apply: the calculations required to comply with the new rules are needlessly complex and difficult to understand. It does not achieve a policy goal: investors do not come to the municipal market as a means of converting ordinary income to capital gain. Its benefits do not exceed its costs: the federal Treasury will realize little revenue from the provision, and municipal bond investors and state and local borrowers are being harmed.

The current treatment of market discount is a disincentive to savings and investment. The new market discount rules have resulted in a more volatile and less liquid municipal securities market and will eventually hamper the ability of states and localities to undertake new investment by increasing their cost of capital. Addressing problems raised by the new treatment of market discount for municipal securities is consistent with the goals of H.R. 9. A bill introduced in the 103rd Congress with bipartisan cosponsorship by Congressman Ben Cardin, H.R. 4714, would have repealed the new the new treatment of market discount on municipal securities. We urge the Committee during its deliberations on H.R. 9 to adopt a similar provision to tax market discount as capital gain, rather than as ordinary income.

I appreciate the opportunity to present PSA's views, and I look forward to working with this Committee as the debate over H.R. 9 continues.

Mr. HERGER. Thank you very much.
Mr. Auerbach, please.

STATEMENT OF ALAN J. AUERBACH, ROBERT D. BURCH PROFESSOR OF TAX POLICY AND PUBLIC FINANCE, DEPARTMENT OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. AUERBACH. Thank you very much, Mr. Chairman.

Let me just say because I am on a panel with others representing different constituencies that I am here testifying on my own behalf.

I am director of the Burch Center for Tax Policy and Public Finance at the University of California. I am an economist and I have studied and testified before this committee on issues of capital formation and the budget many times in the past. My discussion today and my written testimony will be limited to two sets of provisions in titles I and II of H.R. 9 dealing with the indexation and exclusion for capital gains and the NCRS provisions for capital recovery.

Let me begin by summarizing my conclusions.

The combination of the capital gains exclusion of 50 percent and indexing would, for typical assets, easily lead to the equivalent of greater than 60-percent exclusion of gains without indexing. You may recall that in 1978 one of the reasons for increasing the exclusion for capital gains to 60 percent was inflation. If we were ever to go back to the unfortunate inflation rates of the late seventies and early eighties, the combined effect of the 50-percent exclusion and indexing would actually be far greater than 60 percent. So in that sense this would be establishing more generous treatment for capital gains than in the period from 1978 to 1986.

Second, the capital gains reform would cost the Treasury tax revenue in the long run. There are differences in measurement and opinion about the short run. On the basis of the professional evidence, there is little doubt that a capital gains tax reduction will cost revenue in the long run. You may have heard statements to the contrary here today. Those are not based on evidence, and the evidence is all that I can go on.

Taking dynamic considerations into account, that is, looking at macroeconomic feedback effects, would likely increase this revenue loss. That is because the capital gains exclusion that applies not only to newly acquired assets but also to existing assets with potentially large accrued gains has an enormous windfall effect. Windfall effects do not have incentive effects; they do not encourage saving. They encourage consumption, and by providing a very large windfall, a tax change like this would have a much more direct impact on reducing saving than on increasing it. This is particularly so in a full employment economy, as we have now, where increasing consumption is not likely to increase output. That increase in consumption is going to come at the expense of investment, that reduction in investment is going to reduce the growth rate of the economy, and that is going to reduce future tax revenue.

Third, the proposed neutral cost recovery system offers the equivalent of immediate expensing, at least theoretically. Compared to the current system, it is as if you were giving an investment credit for corporate taxpayers in the 35 percent bracket ranging from 2.4 percent for a 3-year property at current inflation rates to about 8.3 percent for a 10-year property.

Fourth, despite the large tax reduction it provides, NCRS is consciously designed in a way that masks its large revenue costs. As is quite clear from the revenue estimates, the costs are much higher in the long run than they are in the short run, and like the capital gains reform, it is best to look at the longer run revenue implications when deciding whether this is something that the Nation can afford.

If you feel that a program like NCRS is something that should be done, you should be prepared to pay for it in the same way that you would pay for the equivalent investment tax credits ranging from 2.4 to 8.3 percent.

Fifth, the NCRS scheme does not eliminate the distortions associated with the taxation of investment income. While it does provide a zero tax for machinery and equipment, it doesn't go far enough even for those assets in taking care of the way they are financed. In particular, if they are financed with debt, there will be a significantly negative tax rate for that kind of investment. As distortionary as positive capital income taxes are, negative capital income taxes are distortionary as well.

Sixth, and finally, from a macroeconomic perspective this is a particularly inappropriate time to introduce large investment incentives. Investment grew at over 13 percent in the past year. It grew at nearly 13 percent from the third quarter of 1992 to 1993. We are operating near capacity overall and near capacity in the capital goods industry, and increasing demand is not the right way to increase saving right now. The better way to increase saving is to reduce consumption, both by the government and by the private sector.

Thank you.

[The prepared statement and attachment follow:]

Capital Formation and the "Contract with America"

Testimony before the Committee on Ways and Means, U.S. House of Representatives

by

Alan J. Auerbach
Robert D. Burch Professor of Tax Policy and Public Finance
University of California, Berkeley

January 24, 1995

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to give my views of the effects of the "Contract with America" on saving and investment. My discussion will be limited to Titles I and II of H.R. 9, the Job Creation and Wage Enhancement Act, which contain proposals to reduce and index the capital gains tax and increase the value of depreciation allowances on business fixed investment. Let me begin by summarizing my conclusions.

1. By providing both a 50 percent exclusion for long-term gains and inflation indexing, the capital gains reform would sharply reduce the tax burden on capital gains. The combined impact could easily exceed that of a 60 percent exclusion of gains without indexing.

2. The capital gains reform would cost the Treasury tax revenue in the long run. Taking "dynamic" considerations of growth into account would *increase* this revenue loss: because of large windfalls to existing capital, the reform would encourage current consumption rather than saving.

3. The proposed Neutral Cost Recovery System (NCRS) offers the equivalent of immediate expensing of the cost of investment in machinery and equipment. Compared to the current system, NCRS provides the additional incentive to invest that would be provided by an investment tax credit ranging from about 2.4 percent for three-year property to about 8.3 percent for ten-year property.

4. Despite the large tax reduction it provides, NCRS is designed in a way that masks its large revenue costs. Like the capital gains reform, it promises short-run revenue gains due to timing. The long-run losses, however, are a better measure of budgetary impact and should be used as a basis for evaluating the proposals.

5. The NCRS scheme does *not* eliminate the distortions associated with the taxation of investment income. Different assets will face different effective tax rates, and debt-financed capital purchases are likely to face quite negative tax rates, making NCRS property a tax shelter for other capital income.

6. From a macroeconomic perspective, it is a particularly inappropriate time to introduce the large investment incentive embodied in NCRS. Business fixed investment is booming and the economy as a whole is operating near its capacity. Added stimulus to investment is likely to exacerbate supply constraints and inflationary pressures.

In short, neither scheme offers a painless reduction in capital income taxation. In an economy with a terribly low national saving rate, fiscal policy that is out of balance, and production that is operating near capacity, this package is likely to work in the wrong direction on all three counts: to reduce national saving, worsen the budget deficit and stimulate production demand.

Let me turn now to a detailed discussion of the proposals.

Capital Gains Provisions

The capital gains tax provisions of H.R. 9 would introduce a 50 percent exclusion of capital gains and also provide for the prospective indexing of asset bases for inflation occurring after December 31, 1994. Like the exclusion, indexing acts to reduce the portion of nominal capital gains subject to tax. Thus, the two provisions together will exclude more than 50 percent of gains from tax. For example, for an asset held for ten years, yielding a total return of 9 percent annually, and an inflation rate of 3 percent, 63 percent of gains would be excluded from the tax base. This exceeds the 60 percent exclusion rate that existed between 1978 and 1986. At the higher rates of inflation experienced in the late 1970s and early 1980s, the exclusion rate would be even higher because the indexing provision would be more valuable.

There are several arguments offered for reducing capital gains taxes or indexing them in this manner, but as I will explain, I find them generally unconvincing.

Revenue Effects

A capital gains tax reduction would lessen the distortion of the "lock-in" effect that discourages investors from realizing their capital gains. As a result, it would lead to more frequent turnover of capital assets and hence more capital gains being taxed. Some argue that the increased tax base would more than offset the reduced tax rate, leading to increased revenue. Unfortunately, there is little empirical support for this argument. While there is convincing evidence that investors time their capital gains realization to take advantage of lower tax rates -- as they did at the end of 1986 to avoid the impending tax increase -- there is no evidence that realizations increase permanently by enough to raise revenues in the long run. Indeed, as I have illustrated in previous research, such a long-run increase in realizations would require an implausible speeding up of transactions and reduction in assets passed through estates.[1] The most recent studies of investor behavior confirm that, while realizations are extremely sensitive to temporary tax rate variations, they are far less responsive to more permanent ones -- not nearly responsive enough to raise revenues.[2] Hence, capital gains tax cuts do cost tax revenue, and must produce other social benefits to offset the revenue loss.

Increased Capital Formation

Proponents argue that capital gains tax reductions will lead to more capital formation and, as a result, generate further revenue gains. However, while reductions in capital gains taxes (or other taxes on capital income) lower the cost of capital, thereby encouraging investment, they affect saving in a second way as well. By raising the after-tax income of households, capital gains tax reductions encourage consumption. Saving will increase only if the first effect outweighs the former. Unfortunately, the impact on the incentive to save and invest will be relatively small, and a retroactive capital gains tax reduction, as is being proposed, provides large windfalls to the owners of existing assets. Such windfalls will have a much more powerful effect in the opposite direction -- to increase consumption and reduce saving.

For corporate investment, there are several factors that attenuate the effect of a capital gains tax reduction. First, as capital gains even now receive favorable tax treatment (they are taxed only upon realization at a maximum of 28 percent and are not taxed if transferred through an estate), the effect of the rate reduction would be muted. Given my past estimates of the advantages of deferral and basis step-up at death[3], the current 28 percent maximum rate translates into an effective rate of about 10 percent. Based on the same assumption, the combination of indexing and the 50 percent exclusion might reduce this to just over 5 percent, yielding a roughly 5 percentage point reduction the effective tax rate on capital. Capital gains taxes primarily affect the cost of equity-financed investment, to the extent that equity returns are received in the form of capital gains and are received by taxable investors. As a rough estimate, if 1) half of all finance is through equity, 2) half of all equity returns are in the form of capital gains, and 3) half of this equity is held by taxable investors, then the drop in the effective tax rate falls by seven-eighths, to about .6 percentage points. For a real, before-tax rate of return of 6 percent, this is like an increase of 4 basis points in the rate of return to saving.

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[1]Alan J. Auerbach, "Capital Gains Taxation and Tax Reform," National Tax Journal 42, September 1989, pp. 391-401.

[2]Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," American Economic Review 84, September 1994, pp.794-809.

[3]Alan J. Auerbach, "Capital Gains Taxation and Tax Reform," Op. Cit.

By contrast to this very small increase in the incentive to save, offering investors a retroactive tax cut on prior appreciation of existing assets bestows a very large windfall that will increase consumption. To a first approximation, the size of this windfall equals the reduction in the effective capital gains rate, again about 5 percentage points, times the total current value of unrealized gains held by taxable investors. The extra consumption this windfall generates likely will more than offset the small reduction in consumer spending induced by the rise in the after-tax rate of return.

Thus, as currently structured, the capital gains tax reform would almost surely increase consumption and reduce saving. This unfavorable outcome could be mitigated somewhat by reducing the windfall to existing assets. One change in this direction would be to require sale or constructive realization of existing assets in order to qualify for indexing. This change would have the additional benefit of increasing realizations and tax revenues. An even more direct measure would be to limit the capital gains exclusion to newly acquired assets or those constructively realized.

Promoting Venture Capital Investment

An argument often made for reductions in capital gains taxes is that they are needed to promote investment in risky enterprises and new businesses that yield much of their return in the form of capital gains. However, a provision targeted precisely toward this objective is already in force: the Revenue Reconciliation Act of 1993 permits an exclusion for newly issued equity in small businesses. Thus, the venture capital argument does not apply to the current changes.

Insulating Gains from Inflation

The tax system generally measures income on a nominal basis, ignoring the fact that some returns merely compensate asset owners for a decline in the real value of their assets due to inflation. This distorts the measurement of income and raises the effective tax rate on asset returns. While a capital gains exclusion has sometimes been justified to compensate for this overtaxation, this is not the best way to alleviate the distortion of nominal taxation. Indeed, the current proposal includes the most straightforward approach, indexing of asset bases, so the 50 percent exclusion cannot also be justified by the need to compensate for inflation.

While basis indexing is the right way to protect capital gains from inflation, there is no reason to single out this one form of capital income when indexing. Since capital gains already receive favorable tax treatment, the inflation tax weighs less heavy on them than on the return to fully taxed capital income such as payments on interest-bearing assets. Failure to index interest not only leaves out an important class of assets, but also keeps in place the *benefits* that inflation provides to interest deductions. Given that borrowers are likely to be in higher tax brackets than lenders, this means that, under the indexing provisions, borrowing to invest in capital assets will actually be encouraged by higher inflation. While indexing is desirable, I see no justification for limiting it to capital gains, particularly when capital gains are already tax-favored and about to become more so. Indexing depreciation allowances, as would be done under the Neutral Cost Recovery System, is another step in the right direction, but does not address the mismatch in the treatment of interest deductions and capital gains.

The Neutral Cost Recovery System

As just noted, the Neutral Cost Recovery System would index the bases of assets for purposes of calculating depreciation allowances. Assets currently written off over three, five, seven or ten years using the 200 percent declining balance method would also effectively receive interest, at the rate of 3.5 percent, on any undepreciated basis, while having allowances shifted to the 150 percent declining balance method. For this group of assets, the new scheme would be approximately equivalent to immediate, first-year expensing of the entire cost of investment.[4]

[4]The equivalence is based on the assumption that the real discount rate is 3.5 percent. If the appropriate rate is lower, the scheme is more generous than expensing. If the appropriate rate is

At an inflation rate of 3 percent and a real discount rate of 3.5 percent, NCRS gives investors facing the corporate tax rate a benefit equivalent to an investment tax credit ranging from a 2.4 percent (with a 50 percent basis adjustment, as during the period 1982-86) for three-year property to 8.3 percent for ten-year property.

The Timing of NCRS Deductions

Since both expensing and investment tax credits are familiar concepts in the tax code, then why does NCRS take the form it does, rather than simply expanding the scope of existing expensing provisions or reintroducing the investment tax credit? There can be only one answer: timing. By shifting from 200 percent declining balance to 150 percent declining balance and then grossing up deductions for inflation and interest, NCRS greatly increases the present value of allowances while shifting them into the future.

Figure 1 illustrates this. It shows the annual deductions for a dollar of investment in ten-year property under existing law and NCRS, assuming a 3 percent inflation rate. During the first three years, deductions are actually higher under current law. Combine this project with projects starting in years 2, 3, 4 and 5, and you could well raise revenue in each of the first five years -- the relevant budget window. You would almost certainly raise revenue in the five years combined. Indeed, all the provisions of NCRS taken together, including those affecting other assets, have been estimated by the Treasury to raise revenue during the period 1995-2000.[5]

Thus, this new system of depreciation would be very costly in terms of revenue. From the perspective of responsible budget policy, we should be prepared to make the same offsetting budget adjustments in terms of added revenue or reduced spending as we would to finance a system of investment tax credits ranging from 2.4 to 8.3 percent.

Ironically, this backloading of incentives may actually make the policy less effective. By offering businesses the equivalent of expensing but only providing payments over time, the government is giving firms an IOU. To the extent that businesses face restrictions in credit markets, it would make more sense for the government to borrow the cash needed to provide immediate payment of the IOU, rather than forcing cash-constrained firms to borrow until the IOU is paid off. Even with its current budget problems, the federal government faces less difficulty raising funds than many businesses do. This is one reason why, in the past, proposed investment incentives have either taken the form of an investment credit, as in President Clinton's original 1993 package, or accelerated depreciation, as in President Bush's 1992 proposal for a 15 percent investment tax allowance.

Is NCRS neutral?

If tax neutrality means equal treatment of different assets, then NCRS fails by giving more generous treatment to machinery and equipment than other assets. If neutrality means a zero tax rate on investment income, then NCRS fails again, even for machinery and equipment. While expensing or its equivalent imposes no net tax on the returns to investment, there are additional provisions that may impose positive or negative taxes on the same returns. For example, as already mentioned, debt-financed investments will still provide full, nonindexed interest deductions. As long as interest is received by those in a lower bracket than the borrower, the combined tax on borrower and lender will be negative. Combined with the zero tax on asset returns produced by NCRS, the result is a net negative tax rate on debt-financed investment in NCRS property. While lower capital income tax rates may make sense, negative tax rates are hard to justify and produce distortions of their own, including new tax shelter opportunities.

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higher, than expensing is more attractive.

[5]Statement of Assistant Treasury Secretary Leslie B. Samuels before the Committee on Ways and Means, January 10, 1995, Table 1.

NCRS and the Macroeconomy

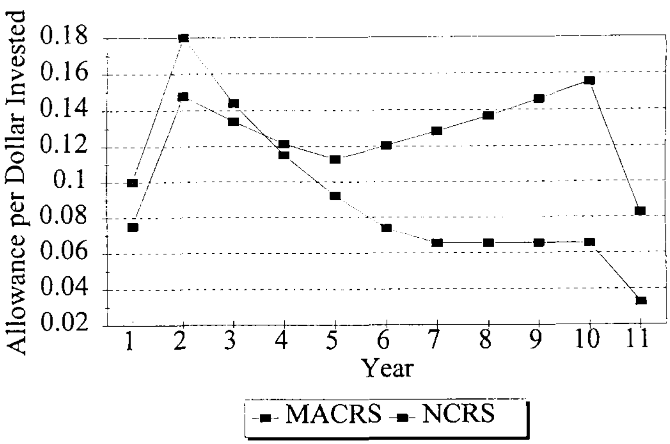
In the past, investment incentives were introduced as a way of stimulating investment and economic activity out of recession. This type of countercyclical policy is hard to practice because it often comes too late and may even exacerbate investment fluctuations by leading investors to hold off investing during a recession as they await yet another investment incentive. However, from the perspective of countercyclical policy, it is difficult to imagine a worse time than the present for the introduction of investment incentives.

With an unemployment rate of 5.4 percent, the economy may well be operating at a capacity above that sustainable at a stable inflation rate. Business fixed investment is growing briskly; it grew in real terms by 12.6 percent between the third quarters of 1992 and 1993, and by another 13.7 percent between the third quarters of 1993 and 1994. For machinery and equipment, the growth rates over the same two years were 17.6 percent and 17.3 percent. An added stimulus for equipment purchases, particularly one not sufficiently balanced by offsetting deficit reductions, would push further against capacity constraints in capital-goods-producing industries and the economy as a whole, adding considerable fuel to present inflationary pressures.

The United States needs more national saving. However, with aggregate demand already strong, a better way to meet this objective is by reducing consumption -- by government as well as households -- rather than trying to increase investment. A serious deficit reduction policy is the most direct way to accomplish this objective.

Figure 1

Depreciation: 10-Year Property



Mr. HERGER. Thank you very much, Mr. Auerbach.

I am just curious, you had somewhat of a different type of seeing the results of our policy than what perhaps several other members of the panel would agree with. Is there anyone who would disagree with Mr. Auerbach who would like to comment on the panel?

Mr. HUARD. The rest of us here are all at something of a disadvantage, none of us are economists. I think you obviously have a difference of opinion. Most of you were here for the prior panel, and I think you really have to decide on the issue of things like capital gains tax cuts whether it is the right thing to do, whether it makes economic sense.

I have been testifying before this committee for nearly 15 years, and the only thing I could say with confidence when econometric estimates are thrown around, and this is going to lose $\$x$ billion and this is going to raise $\$y$ billion, is that you know for certainty that those estimates are going to be wrong, and they are going to be wrong by billions of dollars. About all they can tell you that is helpful is orders of magnitude and trend lines, but the actual numbers themselves imply a precision which, frankly, doesn't exist.

Mr. HERGER. Thank you very much.

Mr. Kleckner, I would just like to comment on your comments, being from an agricultural area myself, I thank you very much for your testimony, and specifically I would like to ask you if you could explain to our committee concerning the increase of maximum exemption for special use from $750,000 to $1.5 million.

My colleague, Mr. Thomas, has legislation that would do that, and I have introduced legislation that would help index land, special use land, particularly for agriculture. And we see so often in our communities where so many of our farms have been out away from the cities at one time, but as the urban area grows we find ourselves that the urban areas now encroach where it is right on top of us but yet our land is valued for what it might be for industrial use perhaps or for building homes on rather than the family farm, and I wish—would you mind commenting a little bit more on how important these two aspects of indexing and raising the special use from $750,000 to $1.5 million—I believe you mentioned $2 million in your recommendation—would be to the family farmer?

Mr. KLECKNER. Yes, thank you, Mr. Chairman. It is extremely important, and you are surely right, that many people were in the country years ago but now the city is moving out. Land valuations have skyrocketed for the new potential use as compared to the use for agriculture that they are now valued at.

We would prefer that there be no exclusion at all, that it be entirely valued at agricultural use. However, we will certainly support the raising from $750,000 to $1.5 million or whatever the proposal might be revised to be.

We think your proposal to index it is extremely important, also. I think indexing in this whole area, this area as well as capital gains, is a key to the future. We will support increasing the exemption up to the $1.5 million. If there is a maximum at $1.5 million, it should definitely be indexed.

It seems to me the government loses nothing in the end. There may be a bit of delay, but in the end if that land is converted to houses, as you mentioned, taxes will be paid on it at that time.

Let's take a $1 million piece of property for farming valued at $5 million, raising the exclusion from $750,000 to $1.5 million, while very helpful still might cause that person to have to sell the farm and get out of farming. So whatever it can be raised to will be of great benefit.

The three-quarters of a million to a million and a half would be extremely helpful. I would hope that the committee would look at even going further than that. But at all costs, your proposal to index needs to be in there.

Mr. HERGER. Thank you very much. Mr. Levin will inquire.

Mr. LEVIN. Thank you very much.

Let me ask those of you, other than Professor Auerbach, who favor these proposals, do you favor them if in the end they are not part of a deficit neutral package? Do any of you favor that or is your position conditioned on over 5 years, it would be 10 in the Senate and I think the 10-year standard would be discussed here, there would have to be no negative impact on reduction of the deficit?

Mr. HUARD. Well, the NAM has consistently taken the position that any tax cuts adopted as a part of the Contract should be financed fully with spending cuts. We don't think you should be playing shell games and financing them with offsetting tax cuts on somebody else. That is basically not going to do anything for economic growth, but we do think if you fully finance any spending cuts adopted as part of the Contract with offsetting spending cuts you will get very positive benefits and that is the way you ought to do it.

Mr. LANE. We would agree with that at NAEA. I think that the purpose of our support for all the initiatives in the business aspect of this bill are going to support a growth in the economy and growth in the profitability of businesses and if that is offset by an increase in the deficit of the government, it just cancels it out, so we would like to see the economy expand, at the same time government revenues will expand, but it would have to be coupled with spending reductions so we don't wind up in a negative position 5 or 10 years out.

Mr. LEVIN. And you don't outline cuts in your testimony, not that you are before the Appropriations Committees. I was a little bit concerned about the response that you can never be sure of predictions, economic predictions. I take it we have to have some reasonable estimation of the likely effect on revenues of any tax cuts.

Mr. HUARD. Well, I think that is correct. My comment was intended to convey the fact that frequently these numbers are tossed around with what appears to be a marked sense of precision and certitude, and I just think they ought to be taken occasionally with a grain of salt.

Mr. LEVIN. Occasionally? The problem is this morning Allen Sinai, who I don't think has an ax to grind, estimated the revenue losses for the next 5 years at, I think, $183 or $193 billion. The estimate of the Treasury Department is $205 billion for 5 years; for 10 years, the estimate of the Treasury Department is $725 billion, which is a considerable chunk of change.

Let me ask Professor Auerbach, what do you see as the economic reasons, in a capital gains proposal, to include a change in rate for existing assets?

Mr. AUERBACH. Well, I think the only justification from an economic perspective would be that you would generate so much additional unlocking of capital gains that the revenue gains from the reduced distortion would essentially pay for itself.

I don't think that is true. I also think that there is an additional issue. People talk about capital gains tax cuts as a savings incentive. The capital gains tax certainly is a tax on capital income. If we are talking about the prospective capital gains tax that people are going to pay, then to a certain extent that will weigh on their decision to save. But I fail to understand how telling people who have appreciated assets that those assets are now worth more, because of a tax reduction, will increase national saving. It is certain to increase consumption. Revenue estimates may differ, and indeed economic estimates may differ, but I don't think there is very much controversy over the statement that people who are wealthier will consume more.

Mr. LEVIN. My time is up. Thank you.

Mr. HERGER. Thank you. Mr. Shaw will inquire.

Mr. SHAW. Thank you, Mr. Chairman.

Mr. Atkinson, I particularly enjoyed listening to your remarks, how it impacts on municipal borrowing. In my own State of Florida almost $8 billion a year is financed in long-term bonds. This has become very important for the building of bridges, roadways, waterways, sewer sanitation plants, all types of things that we want to encourage to be built and taken care of at the local level.

You speak of some complications and restrictions in regard to the exchange of those particular bonds. Could you be specific in your recommendations as to what changes should be made, and also comment particularly on those provisions that were contained in the 1993 tax bill?

Mr. ATKINSON. OK. Actually, prior to the tax change in 1993, all market discount bonds were treated in a uniform fashion. Bonds that trade below par—using 100 as par—a bond trading at 90, the market discount—or the difference between 90 and 100 was treated as a capital gain. The market was very efficient in how those bonds traded.

The change in the 1993 Reconciliation Act created another function because that discount now can be treated, depending on a couple factors in a rule, as capital gains, as ordinary income, or it can be treated as both in the same bond. You basically have investors looking for tax-exempt income, not for ordinary income. If they were, they would be investing in some other vehicle, taxable bonds, stocks, real estate, or some other investment. So what has happened is that people are avoiding bonds that have ordinary income as a result of the rule. In addition, some mutual funds which are large institutional investors, as well as trust departments, and indeed even individuals, are not as concerned about the credit quality of the bond or its yield, but rather whether or not it will be taxed as ordinary income as opposed to tax-exempt income. As a result, market liquidity has changed rather significantly. If you look at the blue list, a publication used in the industry that lists all the bonds owned and for sale, you will see that a majority of those bonds are discount bonds. That is a reflection of the fact that people aren't that interested in those bonds.

I think that the change we propose is a very simple change. It would go back to the pre-1993 level when we had the gain on the sale of discount bonds treated as capital gains.

As I said, I think the revenue impact on the Treasury is very minimal. I think the impact on the market, as a positive factor, would be immediate and reasonably dramatic.

Mr. SHAW. Do you know the revenue figures on that?

Mr. ATKINSON. I don't have the revenue numbers. As I recall, Congressman Cardin asked for an estimate last year from the Joint Taxation Committee and I don't know if that was ever done. Intuitively, I would think it is small, and far out in the distance.

Mr. SHAW. Have the restrictions, do you feel impaired the ability of municipalities to get favorable interest rates from their customers?

Mr. ATKINSON. It is an iterative process. New bond issues are always priced based upon yields in the secondary market. So as secondary market prices get cheaper and cheaper with higher yields, when a local government borrows anew, it will have to pay a higher rate. So new treatment of market discount will have an impact. It hasn't had an impact yet but we have only had 1 year to deal with this.

Mr. SHAW. So you feel whatever revenue we give up would be more than compensated by decreased expenditures for interest by municipalities.

Mr. ATKINSON. I think your savings cost is optimum when there is the most market liquidity and the most market participants. Anything that reduces either liquidity or investors has a tendency to raise rates over the course of time.

Mr. SHAW. And therefore make it more expensive for municipal governments to——

Mr. ATKINSON. Yes.

Mr. SHAW. Thank you, Mr. Chairman.

Mr. HERGER. Thank you. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Auerbach, the last paragraph in your statement would indicate to me that you are not very well impressed with the idea of a capital gains tax reduction. Am I correct?

Mr. AUERBACH. Good reading, yes.

Mr. HANCOCK. I guess we can ignore the rest of your testimony then, can't we? I think it is pretty much a general consensus that capital gains, at least among most of the people in the private sector and the business community, is a way to generate economic activity; to let people benefit from the risk that they take.

The situation that Mr. Atkinson was talking about, the change that gave the authority to the Secretary of Treasury last year to determine what is capital gains when it comes to bonds, there was a lot of resistance to that. When did we get to the idea that you make an investment, you make a profit on it and it takes over 6 months that that is not a capital gains?

Where did that theory come from? Can you tell me?

Mr. Atkinson was addressing that issue especially on municipal bonds.

Mr. ATKINSON. I am not sure where the theory came from, but it is important. While I don't have the legislative history, I believe the capital gains treatment on the market discount has been out there and well established and results in a very effective marketplace. But the change that took place in 1993 has made that a very difficult marketplace and probably has had more unintended consequences than anybody thought about in 1993.

Mr. HANCOCK. Actually, it was a major change in the way people calculated their tax, especially with the new rates, an effective rate of 39 percent on the individual compared to 28 percent.

Mr. ATKINSON. Exactly. In 1993 interest rates were quite low, the long Treasury bond was as low as 5.75 percent, and you didn't have a wealth of bonds trading at a discount. But the change in the marketplace in 1994 going along with much higher rates with the long Treasury bonds at 8 percent, resulted in large percentages of the marketplace now trading at a discount.

So perhaps in 1993 no one was thinking about it as much, but currently over 50 percent of the market is trading in at a discount and it has been a major impediment to the overall marketplace.

Mr. HANCOCK. What about possibilities of some capital losses on municipals? We have a situation that the public is interested in now. What is the tax treatment going to be on that?

Mr. ATKINSON. With the new rules, an investor may lose the ability to offset gains with losses, so it is a worse situation than existed in the past. Indeed 1994 is a good example where many large mutual funds have had negative returns on their funds but they have had to pass through to the investors an actual tax bill for ordinary income which certainly was not intended nor desired.

Mr. HANCOCK. In fact there are a lot of individuals right now, especially this year, that either know the value of their mutual fund investment is going down or having to pay income tax on capital gains that was declared to them during the year even though if they liquidated they would be able to take a loss. I don't think the tax structure was designed to create a problem when there wasn't a profit but that is what we ended up accomplishing.

That is why we have to get back to capital gains where that is simple. You make an investment, if you hold it 6 months or longer and you make a profit, that is a capital gain, doesn't matter whether it is a piece of real estate, a stock or bond or anything else.

Thank you, Mr. Chairman.

Mr. HERGER. Mr. Rangel.

Mr. RANGEL. Mr. Sinclaire, I assume the Chamber has looked over the entire Contract With America, and after analyzing it, you don't see this as any threat to increasing the deficit?

Mr. SINCLAIRE. The Chamber has examined the Contract. We have focused on the business provisions of it. The Chamber, as I am sure you are aware, has called for a balanced budget amendment. Our members feel that that is the second most important item. Based upon a survey we did, the most important is unfunded mandates.

We sent a letter out to every Member, sent one to you last week I believe, and in the overall context we see that the provisions will open up the economy and the incentives will expand the economy.

Mr. RANGEL. Mr. Sinclaire, are you satisfied after reading the Contract that it will not be a negative impact on the deficit? I know you are here to testify about the taxes and I support the tax cuts too, but after all, businesspeople look at the entire economy.

All I am asking is that the package as is, and after reviewing how it is going to be balanced, are you satisfied it would not have a negative impact on the economy? I assume the answer would be yes because you wouldn't be advocating these things if it did.

Mr. SINCLAIRE. The short answer is yes. It will expand the economy in the long run.

Mr. RANGEL. In your testimony you talked about this creating plants and equipment, efficiency and competition, productivity and high-paying jobs. Are you satisfied that in this country we are producing the type of labor market that our industries will need in order to truly be competitive and effective and having the technology and the training for these high-paying jobs?

Mr. SINCLAIRE. We have a base for it, but by getting some of these provisions, we feel we will expand that base. One of the items we would like more done on is the research and experimentation credit.

Mr. RANGEL. Now, I am talking about the labor force, not the technology. God knows America is out front in leadership with that, improving our capabilities even more every day, but I am asking as relates to those people that have to have these high skills, are you satisfied that our labor market has kept up with the technology or is that an issue for your organization at all?

Mr. SINCLAIRE. We feel they work hand-in-hand. As the economy expands, as these new technologies develop, the people will be trained.

Mr. RANGEL. When we talk about the global economy, you are familiar, we have 1 million people in jail, we have 1 million waiting to go to jail, we have people that are drags on society, they are on welfare, they are making children, they are unemployable. All of this is a part of the economy just like you say with plant and equipment.

If you make an investment in plant and equipment, you expect to be more competitive, more productive and it will pay off. I assume that is how you reach the fact that it is neutral as relates to the deficit, and I would assume the Chamber would feel the same about educating and training the work force, it is important so that they too can be competitive against the European common market—you do, don't you?

Mr. SINCLAIRE. We believe it is a combination. We can't segregate and have the training and have the investment. Both will work together.

Mr. RANGEL. Exactly. So you are clear on the investment part here with the tax provisions?

Mr. SINCLAIRE. That is a fair statement, yes.

Mr. RANGEL. I am asking, what are your thoughts about what we should be doing as relates to the training of the individuals so we have the economic incentives and the technology and the research and development and then we have the work force, because you know low-skill jobs are gone with what is left of GATT and NAFTA.

So the people are here and there is a gap, an increase in high school dropouts—what would the U.S. Chamber of Commerce recommend so that we will have a bird with two wings, one with investment for equipment and research and the other in a labor market that understands what to do?

I understand. I have no further questions.

Mr. HERGER. Thank you, Mr. Rangel.

Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman.

Mr. Kleckner, thank you for being here today and for your testimony. As a Michigan Member representing a district that has agriculture as its number one industry, it is refreshing for me to hear a witness come and testify about the views of our agricultural community, especially on tax issues.

Last week I was pleased to introduce a farmer from the Fourth District of Michigan and he did an excellent job of sharing his concerns and the concerns of the American family farmer, and you further elaborated on some of his points that he brought up and I appreciate that.

I want to draw attention to the taxing situation that you mentioned involving the IRS and the possible taxation of associate member dues. I want you to know that I and my colleague on this committee, Mr. Payne of Virginia, intend to reintroduce the Tax Fairness for Agriculture Act within the next week. Our bill will ensure that farm organizations are not unfairly taxed as the IRS appears to be determined to do at this point. I can assure you of our commitment to bring this issue before the Committee on Ways and Means and to resolve the matter.

In your statement, you talk about the importance of a tax deduction for health insurance premiums paid by the self-employed, and that is a critical matter, and it is a critical issue of importance to the Fourth District and to farmers in that area and one that I continue to hear about as I go home.

If you could tell us, in your view, what have been the results of the delay by Congress to address the renewal or a permanent extension of the health care deduction, premium deduction on the agriculture industry, and is it one of the most helpful things Congress can do to help increase health care coverage for farmers?

Mr. KLECKNER. Thank you, Mr. Camp. No question it is causing great consternation and concern in the country. As you all know, business can deduct 100 percent of the health care costs for their employees. In fact, many farm spouses have gone to work mainly to get health insurance, because on the farm as private businesspeople, private entrepreneurs, they have to pay their own with no deduction at all. It had been 25 percent—which is grossly unfair. It ought to be 100 percent as business has, but the 25 percent has been helpful.

I am sure it is true in Michigan, as it is in my State, farmers are paying anywhere from $3,000 or $4,000 at the minimum for just their family, up to $10,000 to $14,000 to get somewhere in the 80 percent coverage. It is costing that much. Health insurance is one of the largest expenses that farmers have to pay today, equal to seed and fertilizer and chemicals and the other production aspects of farming. No health insurance expenses are deductible as a business expense.

The 25 percent, please hurry and get that done and made retroactive. For many farmers March 1 is when they pay their taxes, not April 15, the tax day that many people think about. So time is of the essence. If it can be done at any time, even up to April 15, we will file an amended return but it is costly and time consuming. But the long-term goal ought to be 100 percent simply for fairness reasons to put us at the same level as the rest of the country.

Mr. LANE. Mr. Chairman, could I comment as well. Speaking as a tax preparer, the fact that that first expired in July and then was brought back in and extended to December for that year caused thousands of self-employed people to go to additional expense after they had filed their return to do an amended return just to get a deduction they should have been entitled to in the first place. Now we are going to go into this year without having the ability to deduct it at all.

So I would urge you to do it in time for the farmers to get it in by March 31 and for the rest of the world to do it by April 15 because the additional cost it imposes upon small business is incredible because you have to redo the entire tax return.

Mr. HERGER. I want to thank the testimony of Mr. Kleckner and Mr. Lane. Those of us who represent agricultural areas, the farmer, independent employer have been getting a raw deal for years, have not been treated as the corporations or the large businesses who have been able to deduct this health insurance for years. So we appreciate your testimony.

Mr. English will inquire.

Mr. ENGLISH. Thank you for appearing here today. I was unfortunately unable to attend a portion of this hearing, but I have reviewed your testimony and I appreciate the opportunity to question you. Specifically, Mr. Sinclaire and Mr. Huard, earlier in the first panel we heard some agreement on the notion that investment in equipment is currently the single most important factor in stimulating economic growth and development in this country.

Do you concur with that?

Mr. SINCLAIRE. I can concur to the extent that it is a major factor. Not being an economist, I am not sure if it is the first factor, but it is up there as a very high factor.

Mr. HUARD. I would agree, generally. Again, it is—I guess the term "most significant" is one that people doing econometric analyses might quibble with. Certainly it is extremely important and, from the standpoint of the National Association of Manufacturers, we view improving the climate for investment in new plant and equipment to be one of our top priorities in terms of tax policy.

Mr. ENGLISH. In terms of your—I should say in terms of the position of your membership, those that are internationally competitive, those that are involved in exports, to what extent are they put at a competitive disadvantage with exporters from other countries competing in international markets by the Tax Code?

Is this a common complaint among your membership? Do you have anecdotal evidence to support that?

Mr. HUARD. That is not only a common complaint; it is a widespread complaint. It goes well beyond—I am glad you used the words by the Tax Code, because it goes well beyond having inadequate depreciation systems. It extends to a whole range of issues, particularly the taxation of foreign source income, the fact that for revenue scrounging purposes, ever since the mideighties, we have been building fences around the availability of the foreign tax credit, which is a simple device intended to eliminate double taxation. But in order to squeeze more juice out of the lemon, we penalize multinational U.S. firms doing business overseas and that have overseas operations by constantly chipping away at the availability of the foreign tax credit.

This has been a wonderful development if you are a tax accountant or tax lawyer because nobody understands the foreign source income provisions of the code anymore so everybody pays three consultants to figure that out. But from the standpoint of the taxpayers, it has been an unrelieved disaster.

Mr. SINCLAIRE. There are particular areas of the code which are detrimental in the foreign area such as the AMT. The steel industry which has been down, it has foreign competition, it has a problem modernizing and it cannot take advantage of the tax incentives. By being taxed under AMT, they cannot use the tax incentives, the various investment credits that are allowed. They are down to start with.

We are beating them a second time, they have to pay a tax, and they can't take the incentives. They can't modernize, so they are at an extreme disadvantage. This also applies to startup companies. They also cannot take advantage of the various aspects of the code, the advantages, the incentives, because of the AMT, and that affects our international trading aspects, it does not give them a level playingfield with our international competitors.

Mr. ENGLISH. Thank you. Mr. Kleckner, I particularly enjoyed reading your testimony because I think you vividly brought out a lot of the concerns of agricultural people in my district in regards to the capital gains tax.

I would like to address Mr. Sinclaire and Mr. Huard with regard to the capital gains tax. I know that a large portion of business starts are capitalized by individuals, individuals who are going out into the credit market perhaps based on their own credit but are frequently using their own assets to start a business.

We have had a lot of discussion here today about what impact the capital gains tax would have on the economy. I wonder if you can quantify again, anecdotally, or from discussions with your membership, to what extent the capital gains tax is a substantial deterrent for business starts by entrepreneurs who are trying to use their own resources, who are selling an asset to come up with the capital to launch a business?

Mr. SINCLAIRE. I think the problem is not just their own assets; they have to look for money a lot of times from other sources and also their own money. The question is: Is it more profitable? Do they have an incentive to invest in this business? Should they take that money and invest it for 30 years or should they put it into a Treasury bond which is now in the area of 8 percent?

They do to get something beyond that 8 percent. They could lose everything they put into it, so there has to be that incentive not just in the rate of return, there has to be a built-in advantage such as a capital gain, the reward for the risk taken.

Mr. HUARD. I think the major impediment is the lock-in effect. I am not a trained economist and I haven't run this over a bunch of models but, to the extent that I talk to entrepreneurs, a major obstacle to converting assets to other uses is the fact that they are not willing to pay the capital gains tax.

If you are talking about perhaps liquidating a piece of land that has been in the family for years, they are afraid to sell it because you will pay more taxes than you have made because basically your gains are all inflationary and all paper and the government will confiscate your money so you just sit on it and don't sell it.

Mr. ENGLISH. I have other questions but I know we are running late. Thank you very much.

Mr. LANE. One problem of the hangover of this S&L debacle is that it is still very difficult for a small business startup to get any kind of financing, and so they have to go to other sources. The thing that impedes capital formation for small businesses is this capital gains tax. People have the asset locked up and are not willing to use it. I think if there is a change and if those assets become unlocked, it will be easier to finance startups.

Mr. KLECKNER. Going back to your previous question concerning international competitiveness, agriculture is an international market today. A capital gains tax rate at 28 percent ties up capital, keeping farms from modernizing as father and grandfather hang on because they don't want to pay the 28 percent on the inflation increase. Over a period of a generation or two generations, farms become uncompetitive with our competitors in many countries of the world that have a zero capital gains tax rate or much lower than our 28 percent route.

Even our friends, social service happy neighbors to the north, have a maximum capital gains tax rate of 17.5 percent. I know of no other nation that has a capital gains rate as high as the United States and I think that is absurd.

Mr. HERGER. Thank you.

Mr. Payne.

Mr. PAYNE. I want to thank you, Mr. Kleckner, for coming and speaking on behalf of the farmers of America and I look forward to working with you and with Mr. Camp on ensuring that the unfair treatment of associate membership dues is solved through legislation, not only for your organization, but for organizations like yours throughout the country. Thank you for the testimony.

I have one question having to do with neutral cost recovery. It will take a minute to get there because I need to put it in perspective.

This week we will be voting on the balanced budget amendment and likely will pass that amendment from all indications. That will mean, according to the CBO, if we pass it and the Senate passes it and the States ratify it, that by 2002, in order to balance the budget, we will have to find $1.2 trillion. Having a balanced budget is an objective I think many of us share but it will be very difficult to achieve.

Treasury has come and testified, and Dr. Sinai's numbers seemed to be somewhat similar, that by the year 2002, the tax items in the Contract will add $0.4 trillion to the $1.2 trillion. So now we are looking at $1.6 trillion that we will have to find between now and the year 2002 in order to find our way to a balanced budget. Most people seem to agree that that is the order of magnitude of those numbers.

As I look at these proposals that we are considering today, I see that in the 5-year period the neutral cost recovery shows positive figures but, beyond that, as you move to the year 2002 and beyond, it seems almost to explode in terms of its cost to the Treasury. Consequently the numbers of things that we may have to do and decisions we may have to make to make up for the revenue that may be lost to the Treasury increase as well.

I understand and have voted for in the past capital gains tax reductions. Various people differ about the unlocking effect and how much money that may bring into the Treasury, but certainly I think there is a good case to be made about what reduced capital gains taxes can do in terms of generating positive economic activity.

My question is: As we move through this process and as we have to make decisions that are tradeoffs between our budget and providing incentives to creating more economic activity, it certainly seems that neutral cost recovery is one that we might need to look at very closely to see if this provision is a sensible one on the list.

I would like any of you to comment on this particular proposal, neutral cost recovery, and tell me where you would put it in terms of the order of priority of things that need to be considered by this committee.

Mr. HUARD. My inclination would be to put it fairly low on the order of priority. As Dr. Auerbach has pointed out, there are some problems with it. In connection with the availability of interest deductions, you could actually get negative tax rates. I think the goal of adequate capital recovery, at least from the standpoint of the NAM, ought to be expensing. But you can't get there from here in the context of the current system and you probably have to look at overall tax reform, because expensing, for instance, will work reasonably well in a system where you don't get a deduction for interest paid or dividends paid and the recipient of interest or dividends doesn't include them in income.

Under the current system where a business taxpayer gets an unlimited interest deduction and you combine that with something like accelerated recovery of any kind, you do get some distortions that are probably not desirable.

Mr. SINCLAIRE. I can't indicate where on the list it would fall. For a long time the Chamber has supported a neutral cost recovery system with the point of view of getting the true cost back to the investor or the business.

Looking at the neutral cost recovery system and speaking with various members, they have raised some issues. Where everybody comes down on it, we are not sure yet. Everybody is optimistically cautious about it. One problem is, immediate is, it costs a business if they elect it. Right now they can take 200 percent depreciation, they will have to go back to the 150 percent rate, and the first 5 years will get less of an advantage or a lower tax deduction because of that.

Another concern that I hear is, if you look at the history of congressional action, the word is that this may not be around when it will come into effect to help them. It is going to cost them immediately, will not give them an incentive immediately, and over the long term they are worried about congressional action.

Mr. HERGER. Mr. Christensen will inquire.

Mr. CHRISTENSEN. Mr. Kleckner, I want you to know that as a fellow Farm Bureau member, I look forward to working with colleagues on both sides of the aisle to make sure we get equity back to the farmer on the 25-percent deduction for health care and eventually get that up to 100 percent.

Mr. Auerbach, I wanted to ask you, what did you do prior to your service at the University of California Berkeley?

Mr. AUERBACH. I was a professor of economics and law at the University of Pennsylvania.

Mr. CHRISTENSEN. Prior to that?

Mr. AUERBACH. I was at the University of Pennsylvania for 11 years. For 1 year during that time, in 1992, I was Deputy Chief of Staff of the Joint Tax Committee. I took a leave of absence from the University of Pennsylvania.

Mr. CHRISTENSEN. Have you ever been in the private sector?

Mr. AUERBACH. Briefly after getting out of college before graduate school.

Mr. CHRISTENSEN. I support a capital gains tax reduction. Is there any reason why we couldn't restore the 25-percent deduction to self-employed farmers and move it up to 100 percent? Should they be treated any differently than corporations?

Mr. AUERBACH. You are asking me for an opinion far afield from the current subject. I personally think that it is inequitable. There are many, many problems with the current treatment of health care and this is one of them.

Mr. CHRISTENSEN. Mr. Atkinson, you mentioned that the new tax treatment might make it more expensive for local municipalities to raise capital; is that right?

Mr. ATKINSON. Correct.

Mr. CHRISTENSEN. What other changes to the code could we make to potentially help local governments raise more investment?

Mr. ATKINSON. First, if you repeal the market discount rule, which rolls it back to 1993, that affects this topic. In a wider context, the tax reform bill of 1986 limited rather dramatically what uses tax-exempt bonds can be applied to. I know you have a lot of other things to focus on, but 8 or 9 years after the 1986 Tax Reform bill might be time to look at some of the areas that were eliminated or restricted for tax-exempt municipal bonds. That would help some of the localities, especially if the Congress plans to shift a lot of projects back to the State and local governments. I think a reexamination of the 1986 act is something whose time has come.

Mr. CHRISTENSEN. I want to thank this panel, Mr. Chairman.

Mr. HERGER. I want to thank each of our panel members for outstanding testimony. We will at this time recess for 10 minutes, at which time we will resume with our final panel.

Thank you.

[Recess.]

Mr. HERGER. The Ways and Means Committee will reconvene and if our final panel, Mr. Hiatt, Ms. Kerrigan—we will resume.

Ms. Kerrigan, would you like to begin?

STATEMENT OF KAREN KERRIGAN, PRESIDENT, SMALL BUSINESS SURVIVAL COMMITTEE

Ms. KERRIGAN. Thank you, Mr. Chairman, and members of the committee. I would like to thank all of you today for inviting the Small Business Survival Committee to testify, giving us the opportunity on the important issues of the savings and investment provisions in the Contract With America.

We would also like to congratulate the committee on your leadership for holding hearings on ways that we can further unleash entrepreneurship in America to sustain and encourage long-term growth and economic opportunity.

The Small Business Survival Committee is a 40,000-member nonprofit, nonpartisan advocacy organization. Our membership is as diverse as the small business sector itself, from home-based businesses to small manufacturers to traditional mom and pop enterprises to 1995 entrepreneurs. It represents a wide variety of different types of small businesses in America.

Unfortunately, when we asked a lot of our members, and of course many small businesses across the country what their most daunting obstacles are in running their business, they cite their major problems as being government imposed; namely higher taxes, burdensome regulations or both.

Not surprisingly, more and more Americans, especially small businessowners, are viewing the government as an opponent rather than a partner in their pursuit of the American dream. If there is anything in America that represents the attainment of the American dream, indeed it is owning and operating your own business. So rather than punish investment entrepreneurship and savings in America, the Federal Government needs to encourage entrepreneurship, risk taking and savings.

These components are the foundation for a dynamic opportunity economy. The Contract With America provisions begin to chip away at these government imposed roadblocks that are locking up our true entrepreneurial capacity.

While my written testimony expands on all the elements in the Contract With America which we believe will be helpful to entrepreneurship, I will focus on a few items which zero in on encouraging private sector investment as well as increased savings. Beyond the twin burdens of taxes and regulations which small businesses cite as being their major obstacles, most entrepreneurs seeking to start up or expand an enterprise will tell you of another major obstacle and that is raising capital.

The risky nature of such ventures scares off bank lending officers; therefore, venture capital, whether raised from family and friends or from professional investors, remains a critical source of funding for entrepreneurial enterprises. The current nonindexed Federal tax rate of 28 percent on capital gains remains a formidable obstacle to economic expansion, especially considering the risky nature of investing and starting and operating a business.

The capital gains tax is a direct levy on investment and entrepreneurship, a direct tax on wealth creation. By taking the first step in the Contract With America and indexing and reducing the capital gains tax rate, Congress and the administration would greatly strengthen incentives for investment in entrepreneurship, boosting economic growth and activity. Investment in small entrepreneurial ventures carry significant risk. High risk ventures must at least present the opportunity for rewards. The U.S. Tax Code, especially in its treatment of capital gains, should not impede risk taking and therefore economic growth.

As was mentioned in previous panels, if you look at internationally where we stand on the capital gains tax front, we are not competitive internationally. In the new and continually expanding global economy, it is imperative that the United States be competitive with other nations as it relates to capital gains.

The current nonindexed capital gains tax rate is not competitive internationally. The fiercest competitors of the United States have zero or lower capital gains rates than the United States. While our organization fully supports eliminating the capital gains tax, the Contract With America proposal which, combined with indexation, reduces the top capital gains tax rate to 19.8 percent could be the most progrowth step taken by the new Congress.

Other components in the Contract we also support. We think they will be very critical for small business and entrepreneurial growth.

The clarification of the home office deduction recognizes the changing nature, the tremendous shift in workplace preferences and needs.

Increasing the estate tax exemption from $600,000 to $750,000 only begins to help families who wish to pass on a family-owned enterprise. The U.S. Tax Code should not penalize families who want to do this.

The expensing provision for small businesses in the Contract encourages investment in entrepreneurial ventures, and the American dream savings account provision encourages increased savings, which provides needed capital for investment in small business and the future of America.

All the previous mentioned are good steps to help prime the pump for small business growth.

I will close and thank the committee for inviting the Small Business Survival Committee. We look forward to working with you on these and other issues to help encourage investment and savings and keeping America's entrepreneurial spirit alive.

[The prepared statement and attachment follow:]

Testimony Before the United States House of Representatives
Committee on Ways and Means
Karen Kerrigan, President
Small Business Survival Committee
January 24, 1995

Savings and Investment Provisions in the Contract With America

Chairman Archer, I would like to thank the Ways and Means Committee for inviting the Small Business Survival Committee to testify before you today on the future of small business in America, and how the new Congress and the Administration can begin to further unleash investment and entrepreneurship in America to sustain long term economic growth and opportunity.

The Small Business Survival Committee (SBSC) is a 40,000-member nonpartisan, nonprofit advocacy organization fighting against the growing burden of taxation and regulation on American small business and individuals. Members of SBSC represent a diversity of small businesses and enterprises across America. From home-based businesses, to traditional "mom and pop" businesses, to small manufacturers, to 1995 entrepreneurs and others -- SBSC's membership is as diverse as the small business sector itself.

If there is anything in America that represents attainment of the American Dream, it is owning your own business. Unfortunately, most small business owners and entrepreneurs cite their most daunting day-to-day obstacles of running their business as government-imposed -- namely, taxes and regulations. We hear little about traditional business-related hurdles regarding sales, marketing, motivating employees, or topics that also require tremendous time and resources from the owner. Government has become the main obstacle to small business prosperity, and not surprisingly more and more Americans do not view their government as protector of our great free enterprise system.

Beyond the twin burdens of taxes and regulations which are slowly strangling productive entrepreneurial activity, the United States non-indexed capital gains tax creates another impediment for entrepreneurs wishing to start-up or expand an enterprise. The federal government needs to encourage, not punish, private-sector investment.

**Eliminating Capital Gains Taxes:
Lifeblood for an Entrepreneurial Economy**

Most entrepreneurs seeking to start up or expand an enterprise will tell you of a major obstacle -- raising capital. Encouragement for private-sector investment in small business needs to be enhanced. *While SBSC fully supports eliminating the capital gains tax, the Contract With America proposal which, combined with indexation, reduces the top capital gains tax rate to 19.8 percent, could be the most pro-growth step taken by the new Congress.*

There is no more important economic task than investing both sweat and capital in new ideas, innovations, and enterprises. Yet the risky nature of such ventures scares off bank lending officers. Therefore, venture capital, whether raised from one's family and friends or from professional investors, remains a critical source of funding for entrepreneurial enterprises.

The capital gains tax is a direct levy on investment and entrepreneurship. Investment,and entrepreneurship are the lifeblood of a vibrant economy and remain the engines of economic growth and job creation. The current, non-indexed federal tax rate of 28 percent on capital gains remains a formidable obstacle to economic expansion, especially considering the risky nature of investing, and starting and operating a business.

The potential benefits of reducing and indexing the capital gains tax are clear. Venture capital investment was on the rise as the U.S. capital gains tax rate declined up to 1986; followed by a dramatic downturn as the rate was hiked 40 percent in 1987, from 20 percent to 28 percent. Since the 1986 Tax Reform Act raised the capital gains tax rate by 40 percent, venture capital investment has nose-dived, and federal capital gains tax revenues have consistently run well below government expectations. In fact, according to CATO economist Steve Moore, 1991 revenue realizations (most recent available) equaled $108 billion versus a late-1980's Congressional Budget Office prediction of $269 billion and a Joint Economic Committee prediction of $285 billion.

How the U.S. Stacks Up Internationally -- In the new global economy, it is imperative that the United States be competitive with other nation's on the capital gains front -- the U.S. needs to be a haven and magnet for capital. The current non-indexed capital gains tax rate is not competitive internationally. Belgium, Germany, Hong Kong the Netherlands all have a zero rate on long-term capital gains. Canada, France, Italy and Sweden have lower capital gains than the U.S., with Japan's rate equalling 1 percent of sales price or 20 percent of net capital gain. Even the two nation's with higher nominal rates than the United States -- Australia and the United Kingdom -- allow for capital gains to be indexed for inflation. Hence, the U.S. *real* capital gains tax rate often will exceed the rate in Australia and the U.K., depending on U.S. inflation.

Given the critical and risky nature of investment and entrepreneurship, and the importance of maintaining a competitive environment in a global economy, capital gains should be excluded altogether. A zero capital gains tax rate would ensure that entrepreneurial risk *taking, so crucial to economic growth, would not be impeded by the U.S. federal tax code. The steps taken in the Contract With America to reduce and index the capital gains tax rate is a good start.*

Indexation -- The nominal rate of federal taxation is 28 percent. However, when inflation is factored into the capital gains equation the *real* capital gains tax rate rises substantially.

The lack of indexation creates additional disincentives for investment and entrepreneurship, restraining small-business growth and job creation. In fact, some individuals can wind up paying taxes on real capital losses. That is, after factoring inflation into the equation, a nominal profit on a transaction can turn out to be a real loss, yet the investor still pays taxes on the nominal gains. *Real rates* of capital gains taxation represent severe impediments to keeping America's economy vibrant and growing.

Figure 1 below offers an example of how inflation can impact capital gains tax rates. Listed below are the real capital gains tax rates from 1977 through 1993 on three-year investments yielding a total nominal return of 30 percent. (It is assumed that the investment is closed out at the end of the stated year, for example, the 1985 real capital gains tax rate to an investment made at the beginning of 1983 and sold at the end of 1985.)

The Small Business Survival Committee

Figure 1: Real Capital Gains Tax Rate on Three-Year Investments Yielding a Nominal Return of 30 Percent

Year	Nominal Capital Gains Tax Rate*	Real Capital Gains Tax Rate
1977	35%	191%
1978	28	114
1979	28	175
1980	28	494
1981	20	**Tax on a Real Loss**
1982	20	286
1983	20	71
1984	20	41
1985	20	34
1986	20	54
1987	28	42
1988	33	48
1989	28	47
1990	28	50
1991	28	50
1992	28	45
1993	28	40

* Source: The American Council for Capital Formation

A 28 percent capital gains tax rate acts as a considerable disincentive to investment, while *real* rates ranging from 40 percent to 494 percent to even paying taxes on a real capital loss, amount to economic suicide. Indexation would eliminate inflation as a factor in capital gains determination -- equalizing state and real capital gains tax rates. The lower real rate would reduce uncertainty, and generate investment, economic growth, and job creation.

Who Benefits? Opponents who engage in class warfare rhetoric to dismiss lowering and eliminating capital gains tax rates are employing tactics which the American public, quite frankly, is sick of hearing. "Soak-the-rich" schemes and "fair-share" arguments will continue to backfire on those who feel they can defeat the issue on these divisive grounds. Not only does reducing/eliminating the capital gains tax make sense, but capital gains tend to be spread across a wider income spectrum than many believe. Based on 1992 federal income tax returns, 56 percent of returns claiming capital gains were from incomes of $50,000 or less, including the capital gain. Fully, 83 percent of returns with capital gains were from total incomes of less than $100,000.

Wages and Interest vs. Capital Gains -- In addition to false assumptions about the identification of capital gains just with the wealthy, opponents of cutting or eliminating capital gains taxes often argue that no reason exists for differing tax treatments between capital gains and, for example, wage or interest income.

In fact, there is a distinct difference between wage or even interest income and capital gains -- risk. Capital gains come from growth and appreciation of investments, which tend to carry greater risks than those associated with earning wages or even interest. In particular, investments in small, entrepreneurial ventures carry significant risk. As already noted, high-risk ventures must at least present the opportunity for rewards.

Conclusion on Capital Gains -- Small business is the engine of economic growth and job creation. In order to undertake and/or expand a small business, one needs capital. Without adequate capital, new ideas and businesses either never make it to the marketplace or they die a premature death. With such deaths go products, services and jobs. By taking the first step in the *Contract With America*, and indexing and reducing the capital gains tax rate, Congress and the Administration would greatly strengthen incentives for investment and entrepreneurship -- boosting economic growth and activity.

History shows that class warfare does not make for good economic policy. In fact, during the 1980's, while tax rates declined, upper-income individuals paid a greater share of total income taxes, as the benefits of tax shelters declined and the rewards for working, saving and investment rose. In this environment, from 1980 to 1989, 18 million jobs were created.

The 1986 Tax Reform Act made positive strides by reducing personal and corporate tax rates, but went awry by trying to "pay" for these reductions with an increase in the capital gains tax rate. Indeed, the economy paid a price for this capital gains tax hike in the form of reduced venture capital investment.

The time has come to unleash entrepreneurial capitalism by first reducing and indexing, and then eliminating the capital gains tax.

Entrepreneurial Incentives in the Contract With America

As noted extensively in addressing the importance of reducing, eliminating and indexing the capital gains tax, individuals respond to tax and savings incentives having a profound impact on robust and sustained economic growth. Policy makers need also to look a the changing nature of the economy. Home-based businesses, for example, are booming. Clarifying the deduction for home-offices recognizes our changing work force while reducing questions regarding who qualifies and who does not.

Increasing the estate tax exemption from $600,000 to $750,000 helps small businesses pass on a family-owned enterprise to the next generation -- the U.S. tax code should not penalize families for wanting to keep a business in the family.

The small business expensing provision in the *Contract* encourages investment by allowing small businesses to deduct the first $25,000 in equipment and inventory. All of the above are good steps to help "prime the pump" for small business growth.

The U.S. tax code needs to encourage savings in America -- increased savings provides more capital for investment in small businesses and the future of America. The American Dream Savings Account provision in the *Contract* permits individuals to contribute up to $2,000 into a special savings account. Promoting savings in America will strengthen our country's economic base and encourage savings.

Small business, and the entrepreneurial spirit that drives America, continues to be a constant in our economy -- past, present and future. The U.S. government, whose job it is to protect and preserve America's free enterprise system, has unfortunately become a foe of the private sector. Reforming the tax system so businesses and individuals make decisions on economic merit rather than tax law is an essential component of free enterprise.

The Small Business Survival Committee salutes the 104th Congress and the Ways and Means Committee for its leadership in not only determining how the government can further encourage savings and investment, but also for beginning to look at America's tax system in its entirety and how the government can efficiently and fairly collect taxes from its citizens without eroding individual freedom, or America's free enterprise system.

Mr. HERGER. Thank you very much, Ms. Kerrigan.
Mr. Hiatt.

STATEMENT OF J. DREW HIATT, EXECUTIVE VICE PRESIDENT, DIRECTOR OF GOVERNMENT AFFAIRS, NATIONAL BUSINESS OWNERS ASSOCIATION

Mr. HIATT. Thank you, Mr. Chairman, and members of the committee. My name is Drew Hiatt, executive vice president and director of government affairs for the National Business Owners Association. We appreciate very much the opportunity to appear before the committee and to present our views on the tax and business incentives that are contained in the Job Creation and Wage Enhancement Act, particularly as they affect American small business men and women.

Our members support these changes in the belief that they can and will set the stage for a new American era of expanded economic growth, opportunity, and prosperity. Small businessowners can lead this new era if their representatives on this committee and in the Congress at large will give them the chance.

As the powerhouse of our economy, small businesses know how to lead. America's nearly 22 million small businessowners generate about 40 percent of our GNP, provide more than half our goods and services, and employ 6 in 10 Americans. Over the last 5 years, they have created all of our net new jobs and they continue to help our economy go and grow.

We encourage you as members of this committee and the Congress at large to enact the policies necessary for the small business community to create the economic growth that America needs. Unless this committee and this Congress remove the roadblocks and reform the policies that hold back small businesses, they will never achieve their true economic potential and all Americans will suffer the consequences—in lost opportunity, lost growth, and lost jobs.

It is true that small businessowners are succeeding in spite of these restrictive policies, but they are succeeding against the odds and obstacles because of their determination, hard work and tenacity. If Congress removes the obstacles, there is no limit to what they can achieve.

We believe there is a historic opportunity now to abandon these limiting policies. The goal should be to create an economic climate in this country that is conducive to investment. It is investment that fosters economic growth, prosperity and job creation.

Judging from the way in which revenues from investors and investments are taxed in this country, investment may not be as high a priority as some believe or declare it to be. Our Tax Code punishes, not rewards the very thing and people—risk taking and risk takers—that Congress professes to support. This undermines and even destroys the investment businesses seek to make and nurture. Even worse, it punishes the entrepreneurial risk takers who would launch new ventures or expand new businesses and thereby denies hundreds of thousands of other Americans jobs, opportunities, and wages.

Investment fuels productivity, economic growth, and job creation. Maintaining high taxes or increasing taxes on investment does not. Congress needs to examine whether the sole goal of U.S. tax policy is to raise revenue to finance government services and programs or whether an equally valid objective of tax policy should be to encourage investment.

This policy debate must focus on whether it is better to raise more revenue to support an inefficient, wasteful, bloated government that consumes wealth or to encourage investment by allowing those who create our wealth to keep more of what they earn to invest. We believe that a dollar left in the hands of entrepreneurs can do more good than one sent to Washington and consumed with little or no result.

A new direction in tax policy is needed to ensure that American businesses, particularly entrepreneurial small businesses, will be free to create the growth in jobs our Nation needs. We need an investment-driven tax policy, and one that will promote investment by lowering taxes on profits and creating more capital formation and increased investment.

Disincentives for savings and investment that are ingrained in our current Tax Code must be replaced with incentives for savings and investment. This will put our Nation on a path of growth and economic security in the years ahead. The current tax treatment of capital gains, for example, is an obstacle to the formation of additional capital entrepreneurs need for investment in jobs and growth.

High capital gains tax rates discourage venture capital and risky investments and harm small firms and new enterprises. These investments are critical to our Nation's growth and economic success. A lower capital gains tax rate would help channel more capital to new and growing small entrepreneurial companies—the Nation's leading source of economic growth and job creation.

Of all the negative effects of taxing capital, perhaps none is more pernicious or harmful than that of inflation. The current tax treatment of capital gains is discriminatory and confiscatory since taxes are paid on inflated and illusory, not real and actual gains. Inflation erodes gains.

Capital gains in our view must be indexed for inflation to halt the taxation of gains based solely on exaggerated values. Many charge that cutting the capital gains rate will disproportionately benefit taxpayers in higher income brackets. Underlying much of the opposition to reducing the capital gains tax is a false belief about our economy: That is, if one individual wins, the other must lose.

Investors who save and invest their income and plow it into productive investments not only help themselves but also countless more who share in the benefits from the initial investment. The direct benefits of investments include economic growth, increased productivity, new jobs, higher wages, and improved living standards, to say nothing of additional revenues that government realizes.

To paraphrase President Kennedy, "A rising tide of investment lifts all boats." The National Business Owners Association supports the neutral cost recovery provisions contained in H.R. 9. This will help businessowners recover the full value of an investment in new machinery, equipment or technology over the useful life of an asset.

Moreover, this change recognizes the importance of capital to small business and its ability to invest for future growth.

We also support the proposal to increase the expensing amount for small businesses. This will also fuel investment and job creation.

We also believe it is important to restore the home office deduction that was restricted by the U.S. Supreme Court decision in *Commissioner* v. *Soliman* when the Court denied certain deductions and imposed two additional tests for determining eligibility for deductions. The *Soliman* decision, in our view, penalizes many small businessowners because they choose their homes as their business location rather than a storefront, office building, or industrial park.

Mr. HERGER. Mr. Hiatt, if you could conclude your comments.

Mr. HIATT. Thank you, Mr. Chairman, and members of this committee.

We believe that the Contract With America and its tax and business investment incentives will go a long way to create a new era of economic growth for this Nation and its citizens, and we are in support of those provisions and believe that they will accomplish those worthy goals.

[The prepared statement follows:]

STATEMENT OF
MR. J. DREW HIATT
EXECUTIVE VICE PRESIDENT
DIRECTOR OF GOVERNMENT AFFAIRS
NATIONAL BUSINESS OWNERS ASSOCIATION
ON
THE JOB CREATION AND WAGE ENHANCEMENT ACT
BEFORE
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 24, 1995

Mr. Chairman, Mr. Gibbons, and Members of the Committee, my name is J. Drew Hiatt, and I am Executive Vice President and Director of Government Affairs for the National Business Owners Association. We appreciate very much the opportunity to present our views on the tax and business investment incentives contained in the Job Creation and Wage Enhancement Act of 1995 (H.R. 9), particularly as they affect American small business men and women.

The National Business Owners Association represents nearly 5,000 small business owners, and has an active and rapidly expanding membership. Its philosophy is based on the belief that a vibrant and robust private sector and a strong and competitive free enterprise economy are essential to create and increase economic growth, opportunity, jobs, and prosperity for all Americans. NBOA vigorously represents the interests of its members before Congress as well as federal, state, and local government. It also works to influence and enact national policies that promote economic growth and entrepreneurship. As part of its efforts to advocate and adopt beneficial laws and regulations, NBOA consistently communicates the concerns and legislative priorities of business owners to lawmakers, government officials, the public, and the media.

We commend you, Mr. Chairman, for your leadership in convening this hearing today to examine how changes to the tax code proposed in the Job Creation and Wage Enhancement Act will create a more favorable economic and entrepreneurial climate. Your support of this legislation underscores your longstanding commitment to promoting and enacting sound fiscal and tax policies -- workable policies that are based on common sense and the common good. We gratefully recognize your commitment. As a strong advocate for small business, you understand the daunting challenges that confront entrepreneurs, especially the financial consequences that taxes impose on hard-working small business owners. We appreciate your efforts as well as the understanding and concern you have shown for them over the years as demonstrated most recently by your introduction of H.R. 9. Our members support the tax and investment provisions of the Job Creation and Wage Enhancement Act in the belief that they can and will set the stage for a new American era of expanded economic growth, opportunity, and prosperity.

Small business owners will lead this new era -- if their representatives on this Committee and in Congress will give them the chance. As the powerhouse of the economy, small businesses know how to lead. America's nearly 22 million small business owners generate about 40 percent of our gross national product and provide more than half our goods and services. Small business is the nation's leading employer. Today, six in 10 Americans take home a paycheck from a small firm.

Small business is not only the nation's leading employer, it is also the major provider of new jobs. Over the last five years, small firms have created nine of 10 net new jobs. In fact, according to the U.S. Small Business Administration, they are expected to create more than three-quarters of the 43 million new jobs needed over the next 25 years.

We encourage you, as members of this Committee, and the Congress at large to enact the policies necessary for small business to create the economic growth America needs. Unless this Committee and this Congress remove the roadblocks and reform the policies that hold back small businesses, they will never achieve their economic potential and all Americans will suffer the consequences -- in lost opportunity, lost growth, and lost jobs. It is true that small business owners are succeeding in spite of these restrictive policies. But they are succeeding against the odds and obstacles because of their determination, hard work, and tenacity. If Congress removes the obstacles, there is no limit to what they can achieve. We believe there is a historic opportunity now to abandon these limiting policies. Lawmakers of both parties should work together to lay the groundwork that will help create the new American era of economic growth.

What's Wrong with Our Tax Policy?

On average, the U.S. economy invests 15-20 percent of its income in a given year. Is it enough? Our goal should be to create an economic climate in this country that is conducive to investment. It is investment that fosters economic growth, prosperity, job creation, and wage growth. We say that we are serious about and committed to investment. We say this is one of our highest national priorities, one our highest public policy goals -- but is it really? Judging from the way in which revenues from investors and investments are taxed in this country, investment may not be as high a priority as some in Congress believe or declare it to be. Our tax code punishes, not rewards, the very thing and the very people -- risk-taking and risk-takers -- that Congress professes to support. At best, it is a logical inconsistency and, at worst, a glaring contradiction to say that Congress, as a whole, encourages investment as a matter of public policy and national priority. It is an economic contradiction for some lawmakers to say they support investment in business startup, expansions, in jobs, and economic growth and then to enact tax policies that discourage investment by levying higher -- and some might argue excessive -- taxes on investment. This inconsistent practice undermines and even destroys the investment businesses seek to make and nurture. Even worse, it punishes the handful of entrepreneurial risk takers who would launch new ventures or expand businesses, and thereby denies hundreds of thousands of other Americans jobs, opportunities, and wages.

Investment fuels productivity, economic growth, and job creation. Maintaining high taxes or increasing taxes on investment does not. Congress needs to examine whether the sole goal of U.S. tax policy is to raise revenue to finance government services and programs or whether an equally valid objective of tax policy should be to encourage investment. This policy debate must focus on whether it is better to raise more revenue to support an inefficient, wasteful, bloated government that consumes wealth or to encourage more investment by allowing those who create our wealth to keep more of what they earn to invest. We believe that a dollar left in the hands of entrepreneurs can do more good than one that is sent to Washington and consumed with little result.

Savings and Investment: Keys to Productivity, Economic Growth, and Job Creation

Increased investment benefits the economy. But the United States has not always followed this formula for economic growth. In fact, the U.S. has devoted a smaller percentage of its gross national product to investment than almost any other industrial nation. Over the last three decades, Japan has invested 31 percent of its output and boosted productivity growth by more than five percent per year. Germany and France have earmarked slightly more than 20 percent of their output for investment, achieving annual productivity growth of more than three percent. In contrast, the United States has invested about 18 percent of its output and increased productivity growth just a little more than one percent.

Why has U.S. investment been so low? The answer is high capital costs. Savings provide funds needed for investment, and are an important source for investment capital. The problem has been that Americans do not save as much as many foreigners do. Consequently, our national rate of savings is one of the lowest worldwide.

An international survey conducted by the American Council for Capital Formation Center found with regard to personal saving incentives that the United States ranks among the lowest on a list of twelve countries. The U.S. capital gains tax rate on long-term gains on portfolio securities is higher than that of all other countries except Australia and the United Kingdom and even these countries index the cost basis of an asset for inflation. Four of the twelve nations tax interest income at rates below the U.S. maximum rate. Total income taxes (individual plus corporate) on dividends are lower in most countries than the United States because most other countries have some form of dividend tax relief. With respect to individual retirement account deductions, these were found to be more generous in five of the twelve countries than they are in the United States. The study also found that half of the twelve countries allow deductions or tax credits for life insurance premiums, while the United States does not. And individual social security contributions to government-sponsored plans are deductible in most of the twelve countries, while they are not in the United States.

In view of weak U.S. savings incentives, it is no wonder that the U.S. personal savings rate, which averaged nearly 7 percent of disposable income over the 1975-1991 period, is far below that of our major competitors. The study found that Japan, for example, had a personal savings rate for this period of 17.3 percent; Germany's rate was 12.7 percent; Canada's was 12.5 percent. The increase in personal savings rate is important in promoting U.S. economic growth and providing funds for investment.

In recent years, private savings have been diverted away from investments and used to finance public deficits and government spending. This has also contributed to higher capital costs. The resulting problem is that less money is available for investment or, where it is available, its cost is prohibitive.

Today, the great debate focuses on the best way to encourage investment. The best strategy for boosting investment would appear to be to create incentives for private investors. Cutting the tax on capital gains is one example of an incentive that would work. Reducing the tax will encourage investors to buy stocks of companies that retain earnings. This will lower the firms' cost of capital, while providing incentives for saving. Investment income that is taxed encourages consumption at the expense of savings. What we need is to promote investment and savings for the long haul. This is the key to productivity, job creation, and economic growth.

Investing for the short-term is short-sighted. Entrepreneurs need to invest today for the future. They need "patient" capital, long-term capital. Because entrepreneurs need "patient" capital, it is critical to eliminate the obstacles that often discourage investment for the long haul. Business owners and aspiring entrepreneurs must have capital in adequate supply to grow companies and launch new ventures. Congress' goal should be to create a highly favorable investment climate that will enhance and accelerate economic growth, business expansion, and job creation on an unprecedented scale.

Due to realities of a global economy, it is necessary to encourage higher levels of investment and spending in the U.S. economy. American businesses and workers will continue to compete for customers against major competitors in Japan and Europe as well as in the strong and emerging economies of the developing nations. Increased investment generates more productivity, which is the cornerstone of true economic wealth. Throughout our history, we have led the world because of our willingness to invest in new ideas, new opportunities, and people. This has helped us create the world's largest and richest economy. We will always reap the reward of investment today, but the United States must continue to be a nation that saves and invests for the future if it is to continue to be the world's economic leader tomorrow.

A New Direction for U.S. Tax Policy: Toward A More Investment-Driven Policy and Economic Growth

A new direction in U.S. tax policy is needed to ensure that American businesses, particularly entrepreneurial small businesses, will be free to create the growth and jobs our nation needs. Maintaining and or levying higher taxes on investors and investment are contrary to the national objective of long-term economic growth and employment. That is why we need an investment-driven tax policy, one that will promote investment by lowering taxes on profits and creating more capital formation and increased investment.

Small business owners are leading the nation in economic growth and job creation. Yet, the tax code offers very little help in the form of deductions and write-offs that would assist small business owners in creating more jobs and growth through investment. It is important to remove additional disincentives to investment. A new direction in U.S. tax policy would recognize that the sole purpose of tax policy is not only to fund government services and programs, which is merely a collection of revenues, but that an equally important priority is to encourage promote investment that will contribute to economic growth, job creation, and prosperity for all Americans.

We must encourage Americans to save more to promote capital formation for investment and growth in jobs. We must remove the disincentives for savings that lead to consumption of income and instead provide incentives for Americans to save more of their income. Ideas such as American dreams savings accounts, as proposed in the Contract with America, take a step in the right direction toward creating an environment in this country that will encourage savings. Unless Americans begin to save more, American businesses will continue to pay the price for the high cost of capital and this price will be reflected in lower levels of productivity, less economic growth, and fewer jobs for all Americans. Lowering the capital gains tax rate and adjusting gains for inflation would help increase investment. This would create large pools of capital for companies -- both start-ups and existing companies -- to tap for economic growth. It would also create a tremendous potential for enormous economic expansion, for risk-taking, and for new technological development, which is what we need to become more competitive with foreign countries. Congress needs to remove the obstacles, the barriers in the tax code which make it more attractive to consume income rather than to save and invest it.

We need to provide additional incentives for entrepreneurs to invest in their businesses and to recover the full and real cost of their investments. At present, small business owners who invest in their companies are unable to recover the full cost of their investments in depreciable property because inflation erodes the present value of their investments and the time value of money is not accounted for in current write-offs. It is important to remove this obstacle to increase investment.

Disincentives for savings and investment that are ingrained in our current tax code must be replaced with incentives for savings and investment. This will put our nation on a path of growth and economic security in the years ahead.

THE JOB CREATION AND WAGE ENHANCEMENT ACT

Cutting Capital Gains and Indexing Them for Inflation

The House Republican Contract with America includes three capital gains incentive provisions: (1) a 50 percent capital gains deduction, (2) indexation of capital gains for inflation, and (3) allowing homeowners who sell their homes at a loss to deduct that capital loss. The 50 percent capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1995. The capital assets indexation would apply to inflation (and sales of assets) after December 31, 1994.

Fifty Percent Capital Gains Deduction

The bill would allow taxpayers -- both individual and corporate -- to exclude one-half of capital gains from income tax, with the effect of cutting the capital gains tax rate to one-half the rate of ordinary income, which currently is capped at a rate of 28 percent. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending upon the individual's tax bracket. Corporations would be subject to a top effective tax rate of 17.5 percent. The measure would not change the 1-year holding period requirement for long-term capital gains.

The 50 percent capital gains deduction would be taken against gross income. This change would ensure that the excluded half of the capital gain would not increase Adjusted Gross Income (AGI). Because capital gains are currently included in AGI, many taxpayers must forfeit personal exemptions and itemized deductions if they are above certain income thresholds. This change would have the effect of reducing the effective tax rate on capital gains by easing the impact of the personal exemption phaseout and the limitation on itemized deductions.

The capital gains deduction would not be a preference under the Alternative Minimum Tax (AMT). Therefore, the 50 percent deduction would be excluded from the AMT. This exclusion helps taxpayers avoid another tax rate on capital gains.

The bill would also reinstate the pre-tax Reform Act of 1986 rule for capital losses: only one-half of net long-term capital losses, to the extent that they exceed net short-term capital gains, would be deductible.

Capital Gains Indexation

The bill would halt the practice of taxing individuals and corporations on inflated capital gains. Under current law, taxpayers must pay capital gains taxes on the difference between an asset's sales price and its basis (the asset's original purchase price, adjusted for depreciation and other items), although the increase in value may be the result of inflation and not real gain. The measure calls for increasing the basis of most capital assets to account for inflation after 1994. Taxpayers would be taxed only on real, not illusory, gains.

Loss on the Sale of a Home

Under the bill, taxpayers who sell their principal residence at a loss may deduct that as a capital loss. Current law does not allow homeowners who sell their homes at a loss to take this deduction.

Why a Cut in Capital Gains Is Needed and Why Gains Should be Indexed

Capital is the lifeblood of enterprise and economic growth, yet too often risk-takers -- energetic entrepreneurs with promising ideas and practical dreams -- encounter obstacles in obtaining the capital they need to launch a new venture. Even well-established business owners -- with strong track records and profitable companies -- can run up against the same problem when seeking additional sources of financing to expand their operations. Our nation's future success depends on entrepreneurs and small business owners who can help fuel our growth and drive our economy. They create our jobs and contribute to our growth and prosperity. But without the capital to start and expand businesses, they cannot succeed and ultimately we all will pay a price for their lack of success. It is time that Congress address the need for increased capital availability within the context of efforts to encourage increased business formation and expansion through investment. The current tax treatment of capital gains is an obstacle to the formation of additional capital that entrepreneurs must have access to for investment in growth and jobs.

The Effects of Taxing Capital Gains

Reduced Savings and Its Effect on Capital Formation and Investment

Subjecting capital gains to taxation penalizes those who save and invest, forcing them to pay tax not once but twice on the same income. From the standpoint of tax fairness and equity, the capital gains tax is punitive and discriminatory. High tax rates on capital gains tend to discourage savings because they lower the after-tax rate of return on savings. Such rates can distort individual decisions about savings. Faced with a choice between saving income -- with a lower rate of return later -- or spending it now, many Americans elect to consume income now rather than defer future consumption through savings. Since savings is essential for capital formation, the individual preference for current consumption as compared to saving for future consumption stymies capital formation. Reduced availability of capital equates to lower levels of investment in business startup, plant and equipment as well as in labor, with the consequence that productivity suffers and workers' wages can drop.

Decreased Risk-taking and Investment

High capital gains tax rates discourage venture-capital and risky investments and harm small firms and new enterprises. These investments are critical to our nation's growth and economic success. Over the last several years, entrepreneurial small companies have contributed to and accounted for much of the economy's growth and job creation. Growing and emerging new companies need steady infusions of risk capital to nurture, support, and sustain expansion. Entrepreneurs and small business owners need investors to buy stock and to invest in their companies. But investors will only commit their capital to such investments if they can be assured of a fair and reasonable return on their investment.

The taxation of capital gains acts as a significant drawback to riskier investments in new startup companies or those undertaking expansion. A lower capital gains tax rate would help channel more capital into new and growing small entrepreneurial companies -- the nation's leading source of economic growth and job creation. This, in turn, would create a tremendous potential for increased economic expansion, encourage risk-taking on a larger scale, spur innovation. boost productivity, and add more Americans to company payrolls.

The Threat to U.S. Competitiveness

Higher capital gains tax rates undermine U.S. industrial competitiveness and threaten to challenge our longstanding role as the undisputed economic leader of the world. Capital is the key ingredient of investment and investment fuels growth and expansion; however, when capital costs too much, investment declines and productivity and economic growth suffer. Higher capital gains rates tend to discourage savings and investment, raising the cost of available capital. The effect of higher capital costs -- either because of reduced supply or increased demand -- means lower levels of investment in plant and equipment, technology, and labor. As a result, goods and services that are produced under this scenario cost more to produce. These costs must be reflected in higher consumer prices, making products less price competitive in the marketplace.

The United States already faces significant competitive challenges around the globe. In many cases, our competitors benefit from more favorable tax treatment of capital gains and savings, combined with lower labor, raw materials, and overhead costs as well as reduced regulatory and paperwork burdens. This strengthens their advantages and increases their opportunities in the marketplace. Congress needs to stimulate investments in technology, plants and equipment, and people to maintain our technological superiority, boost productivity, and increase our global competitiveness. That is why a lower capital gains tax rate is needed to reduce the cost of capital and to increase its availability.

Locking in Investors and Investments

Investors who contemplate selling assets or changing their investments understand the effect capital gains taxation has on anticipated profits from asset sales. They must weigh whether the expected return from a sale of an asset will result in a desired profit after the capital gains tax has been levied. When it is clear that the profit is less than expected, investors will generally forego or postpone the sale of an asset. This phenomenon of investors holding onto assets because the expected net return derived from the sale of an asset after the payment of capital gains tax is less than desired is known as the "lock-in" effect.

Taxing capital gains often saddles investors with assets they do not want but cannot afford to liquidate because of the undue financial consequences of such a decision. This can cause capital to idle in non-productive assets. Moreover, the lock-in effect deters the redeployment of capital to more useful and productive investments. Since the lock-in effect caused by higher capital gains taxation can distort and influence behavior, many investors seek out investments that will minimize tax liability. In such cases, tax avoidance becomes a major strategy in considering investments rather than pursuing investments that make good economic sense and, while riskier than others, also provide higher rates of return.

Lowering capital gains taxes would unlock a huge amount of wealth in homes, land, farms, stocks, bonds, and other assets; free investors to pursue new investments; and increased realizations of capital gains would generate new revenues.

Inflation

Of all the negative effects of taxing capital, perhaps none is more pernicious or harmful than that of inflation. The current tax treatment of capital gains is discriminatory and confiscatory, since taxes are paid on inflated and illusory, not real and actual, gains. Inflation erodes gains. Under current law, capital gains taxes are applied to nominal gains, which are gains that are not adjusted for inflation. This means that the effective tax rate on real capital gains is actually higher than the current prescribed legal rate. Since the appreciation in value of most assets, particularly those held for longer periods, is attributable to inflation, taxing nominal gains destroys the wealth of entrepreneurs, individuals, and families.

Capital gains must be indexed for inflation to halt the taxation of gains based solely on exaggerated values. This would help investors who currently avoid selling their capital assets to take advantage of higher risk investments -- the chief source of economic growth. Further, it would allow investors to buy assets based on their true merits without regard to the effect of inflation on future returns or planning sales of assets based on artificial holding periods. Indexing capital gains for inflation also would help small business owners who want to sell assets to create or expand a business or sell their company.

In Defense of a Capital Gains Tax Cut: Answering the Critics

Critics of reducing the rate of capital gains have attacked the proposal on many fronts.

Argument: A Capital Gains Tax Cut Only Helps the Rich

Many charge that cutting the capital gains rate will disproportionately benefit taxpayers in higher income brackets. They contend that at least half of the direct benefits of a cut in capital gains will go to the top two percent of taxpayers nationwide. Opponents are concerned that this will result in a windfall to America's richest individuals and corporations at a time when there is a growing disparity between the country's poor and rich.

Underlying much of the opposition to reducing the capital gains tax is a false belief about our economy: that is, if one individual wins, the other must lose. Investors who save and invest their income and plough it into productive investments not only help themselves, but also countless more who share in the benefits from the initial investment. The direct benefits of investments include economic growth, increased productivity, new jobs, higher wages, and improved living standards, to say nothing of additional revenues that government realizes. Thus, investments produce a strong multiplier effect within the economy, helping investors and those who are beneficiaries of their investments. To paraphrase President Kennedy, 'a rising tide of investment lifts all boats.' But when higher capital gains taxes punish investors by devouring the value of their investments or diluting them through the taxation of inflated gains, they respond by saving and investing less. Ultimately, their reluctance -- or refusal -- to save and invest hurts the economy and everyone in it.

If Congress wants to create more jobs, expand the economy, improve income and wage opportunities, it must encourage more investment. To foster greater investment, Congress must first remove the disincentives to savings and investment -- for rich, middle-class, and lower middle-class investors alike. Individuals respond positively to investment incentives but they react negatively and predictably to investment barriers such as higher capital gains rates. Congress must create incentives for risk-taking, job creation, and expansion, and lowering the capital gains rate is a first step. This reform would help all income classes because it would improve the economy's performance and growth potential. It is a tenet of sound economic policy that economic growth increases when the cost of activities that foster it are lowered.

Critics of lowering the capital gains tax deride it as a boon to rich taxpayers. They labor under a false assumption; namely, that not all those who pay capital gains taxes are rich. Low- and middle-income taxpayers bear a significant share of the cost as well. The reality is that many Americans with limited incomes have investments in stock, rental properties, and small businesses. They face the capital gains tax when they sell such assets. Michael Schuyler, Ph.D., of the Institute for Research on the Economics of Taxation, found that:

" Most distributional tables purporting to show who pays the capital gains tax overstate the wealth of people with capital gains because they include in a taxpayer's income the entire capital gain in the year in which the person realizes the gain. Since gains are typically realized irregularly, people tend to have unusually high incomes in the years when they realize their gains. A better measure of income is found by averaging the gains over several years' before adding them to income. And these corrected tables indeed show that the middle-class forks over a significantly higher share of the capital gains tax than is usually acknowledged. In addition, as politicians in Washington have sought higher taxes to finance more government spending, they have frequently found it convenient to redefine "wealthy" at lower and lower income levels."

Cut The Capital Gains Tax To Help All Income Classes
IRET Byline. September 22, 1989 No. 79

A high capital gains tax rate should not be used to extract more taxes from income earners in the top tax brackets any more than it should be used to punish those who are lower and middle-class income brackets. Lowering the tax on capital gains has the potential to help Americans in all income classes by sparking greater growth in the economy.

Argument: A Capital Gains Tax Cut Will Break the Treasury and Increase the Deficit

Opponents of a lower capital gains tax rate maintain that reducing the rate could cause the budget deficit to rise unless Congress offsets the tax cut with spending cuts. They say that Congress must find the cuts or risk further interest rate hikes from the Federal Reserve. Opponents also argue that a cut would kill prospects for improved economic growth that Republicans say they want to stimulate. The Congressional Joint Committee on Taxation estimates that the Republicans' proposed capital gains tax cut would cost $56 billion in lost tax revenue over the next five years. After that, it predicts. the cost of a capital gains tax cut would rise. mostly due to proposed adjustments in future capital gains to offset inflation. Opponents point out that Congress cannot dismiss the fact that the $160 billion deficit will begin rising again next year. and that the costs of the capital gains tax cut would add to that cost without offsetting spending cuts

Republicans have vowed to cut spending to make room for the cuts they propose. The capital gains tax cut will not be a revenue loser as critics contend; in fact, it could prove to be a net revenue gainer. Mr. Gary Robbins, President of Fiscal Associates Inc, a leading proponent of dynamic estimating, predicts that the capital gains tax cut would produce $126 billion in new revenues by fostering widespread economic growth. We believe this could result in a windfall to the U.S. Treasury. A lower capital gains rate could boost tax revenues by encouraging investors to realize their gains sooner. A cut would encourage investors to liquidate assets and put their money into productive investments to such a degree that the cost of a capital gains tax cut would pay for itself in higher tax revenues later.

Critics say that is an unproven economic hypothesis. Yet, Warren T. Brookes, a respected journalist and economist, recounts in his book, *The Economy in Mind*, that the opposite is true:

"When the top marginal tax rate on capital gains was 46% (1946-63), or nearly double Mellon's maximum range of 25%. the taxes paid on capital gains steadily declined from 1961 through 1963. Then, as a result of the Kennedy across-the-board tax cut of 1963-64, the top marginal tax rate on capital gains was reduced from 46% to 35% -- a cut of 24%. The revenues from this tax steadily rose, by 25% in 1964 and 27% in 1965. By 1968 they had nearly tripled in constant dollars, at a substantially lower marginal tax rate.

Unfortunately, this growth in capital gains and investment was hit hard, first by a surtax in 1968-69, and then by an increase on capital gains put through by Senator Edward M. Kennedy in 1969, which had the effect of raising the top marginal tax on capital gains to its highest level in U.S. history, 49% in 1970. The results were immediately destructive. Tax revenues from capital gains plummeted, and over the next eight years remained consistently at a level nearly $1.5 billion lower than they were in 1968.

Within a year of this tax increase, the entire equity capital market for small companies (which account for over 80% of all new jobs and 65% of new inventions) fell apart; and it continued to disintegrate over the next eight years. In 1969, before the tax hike, there were nearly 700 new stock offerings by small companies, with a total 1980 value of nearly $3 billion. But by 1977 this equity market had shriveled to only 13 offerings and less than $55 million -- a compound annual decrease of nearly 40%, the worst collapse in equity sales in modern U.S. history.

For all intents and purposes, Senator Kennedy's innocent little tax hike had virtually killed off the small-business equity market and countless thousands, even millions, of jobs along with it."

The Economy in Mind, pp. 59-61

Later in the same chapter, Brookes describes the effort involved in trying to reverse the increase on capital gains.

"It was perhaps the best illustration of the Laffer Curve in action -- so good, in fact, that a young Republican congressman, the late William Steiger of Wisconsin, decided in 1977 to try to convince an overwhelmingly Democratic Congress to repeal this massive mistake [sic: Senator Edward Kennedy's bill to raise capital gains] by showing his colleagues that as much as half of the new equity capital for the nation's fast-growing high-technology industries was, by now, coming from overseas rather than from our own equity markets.

The dramatic fall, both in capital-gains tax revenues and in equity-investment, convinced the Congress to turn down President Carter's own surprising plan to increase the capital-gains tax rate still further (to 52.5%) and instead to adopt Congressman Steiger's amendment, which cut the rate from the 49% level down to 28% -- a 43% tax reduction.

The Carter administration, in an unsuccessful attempt to block this bold move, had warned that the Steiger Amendment could reduce Treasury revenues by more than $2 billion during the first year. Instead, the Steiger cut actually *raised* capital-gains tax revenues modestly in 1979, the first year following the 43% reduction, as the number of new equity offerings suddenly jumped from 20 per year to 81 in 1979. Then, during 1980, a recession year, 237 companies offered stock to the public for the first time (the greatest number since 1972) and sold $1.4 billion in shares -- a huge increase from the 81 new companies that had sold $506 million in 1979."

The Economy in Mind, pp. 61-62.

NBOA Position on Cutting Capital Gains and Indexation

The National Business Owners Association strongly supports the capital gains tax cut and indexation provisions contained in Job Creation and Wage Enhancement Act as introduced and as originally proposed in the Contract with America. We asked our members in a survey whether they would favor a capital gains tax cut. Respondents overwhelmingly expressed support for legislation to reduce the rate of taxation on capital gains. NBOA believes that the capital gains relief incentives included in the bill will create a climate that will encourage investment; promote increased growth in the economy, jobs and wages; and strengthen U.S. competitiveness.

Neutral Cost Recovery

The House Republican Contract with America includes a "neutral cost recovery" proposal. This proposal would increase depreciation deductions to approach the economic equivalent of expensing. Currently, the tax code does not allow businesses to recover fully (on an economic basis) the cost of investments in depreciable business property. The proposal would increase depreciation deductions to account for inflation and the time value of money. The neutral cost recovery provisions would generally apply to property placed in service after December 31, 1994.

Current law prohibits company owners from taking an immediate write-off for the investments they make in depreciable assets such as plant, equipment, and other assets. Consequently, they must spread the write-offs over longer periods. This practice hurts small business owners in several ways. It reduces the real present value of the write-offs since they do not account and compensate for the twin effects of inflation and the time value of money. By not allowing business owners to factor in the costs of inflation and time value of money and to adjust their write-offs on depreciable property to reflect these costs, business owners are unable to recover the full costs of their investments.

Under the neutral cost recovery proposed in the Job Creation and Wage Enhancement Act, businesses would be allowed to recoup the cost of their investments. The plan would allow companies to adjust their depreciation write-offs yearly by applying a 3.5 percent discount rate and the rate of inflation. This would make the write-off amount equal to the full purchase price of an asset.

NBOA Position on Neutral Cost Recovery

The National Business Owners Association strongly supports the neutral cost recovery provisions contained in H.R. 9. This bill will give business owners and entrepreneurs a powerful new investment incentive, allowing them to recover the full value of an investment in new machinery, equipment or technology over the useful life of an asset. Moreover, these changes recognize the importance of capital to small business and its ability to invest for future growth. We believe further that this provision will exert a positive influence on investment and wages as it seeks to correct an inequity in the current tax code that harms small business. These changes will also help promote rapid economic growth by spurring increased investment. We believe that such growth will fuel business startup and expansion as well as spark new job creation.

Increasing the Expensing Level for Small Business

The House Republican Contract with America also proposes an increase in the amount of property that a small business can "expense" or deduct in the year of purchase. Current law allows a small business (a business purchasing $200,000 or less of eligible property) to take an immediate deduction on the first $17,500 of property it acquires. Remaining property is generally subject to regular depreciation rules. The proposal would allow small businesses to fully deduct an additional $7,500 from each year's earnings for purchases of equipment and inventory up to $25,000, compared with $17,500 now. The provision would be in effect for taxable years beginning after December 31, 1995.

Expanded write-offs for investments in plants and equipment for small business are needed to ensure that small firms have access to capital to invest in growth and expansion. Entrepreneurs need to invest today for the future, and that long-term investment must be nurtured. Yet, the present tax treatment of investments in plant and equipment has not favored long-term investment as it should nor favored the investments of small business men and women who are driving our nation's growth.

NBOA Position on Increasing Expensing for Small Businesses

The National Business Owners Association strongly favors the proposal to increase expensing amount for small businesses as contained in the Job Creation and Wage Enhancement Act. This legislation provides an important investment incentives for small business owners, while enabling them to recover more of the cost of their investments. This, in turn, will increase the availability of additional capital for future investment.

Clarifying the Home Office Deduction

H.R. 9 would clarify the home office deduction by making two changes. First, an office in the home would qualify as a principal place of business if the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular basis by the taxpayer and the office is necessary because the taxpayer has no other place to perform those activities. Second, qualifying home office expenses would also include those allocable to the storage of product samples. The changes to the home office deduction generally would be effective for taxable years beginning after 1995.

The home office deduction was restricted by a 1993 U.S. Supreme Court decision in *Commissioner v. Soliman,* when the court denied certain deductions and imposed two additional tests for determining eligibility for deductions. To qualify now, a business owner must: meet clients or customers in the home office; and second, earn the firm's revenue there as well. The Soliman decision penalizes many small business owners because they choose their homes as their business location rather than a store front, office building, or industrial park. This ruling fails to recognize the fundamental realities of American business today, including its changing nature; how, when, and where business is conducted; as well as the needs of entrepreneurs who are leading our economy.

The bill would restore the deduction for home office expenses to pre-Soliman law. Taxpayers would not be required to meet the criteria determined by the Court. Rather, the bill allows a home office to meet the definition of a principal place of business if it is the location where essential administrative or management activities are conducted on a regular and systematic basis by the taxpayer. To avoid potential abuses, the bill would require that taxpayers have no other location for the performance of the administrative or management activities of the business.

The home may be the best incubator for fledgling businesses that are struggling to survive and succeed. Few new small business owners, if any, can afford the luxury of rented office space. That is because a major problem facing new enterprises is cash flow. Many entrepreneurs launch new firms on a shoestring budget, enduring long hours, limited resources, and lean or no profits before they become successful. For these business owners, the home office deduction can boost the chances that the company they have started and worked hard to build will be a success. That is why the loss of the deduction represents a major blow to those whose success often hangs in the balance and hinges on taking advantage of every break that can keep the company financially afloat and growing.

The Soliman decision ignores the changing face and needs of business. The advent of advanced and ever-improving computer and telecommunications technology has empowered millions to work from their homes. Entrepreneurs are no longer tied to an office or to a store front. Now, thanks to technology, they can work from their homes. Technology has changed the way we think, communicate, work, and do business -- and where we do these things. New technologies are revolutionizing business and helping us to realize huge improvements in productivity and service. As technology becomes cheaper due to innovation, more Americans can afford to work for themselves and from their homes. U.S. tax policy should not discriminate against home businesses because a taxpayer chooses to operate a business out of the home.

NBOA Position on Clarifying the Home Office Deduction

The National Business Owners Association strongly supports efforts to restore the home office deduction. Restoring the home office expense deduction could affect between 20 and 40 million Americans who work from their homes.

Increasing the Estate Tax Exemption

The Contract with America would raise the estate and gift tax exemption equivalent to $750,000. The current $600,000 exemption has not been increased in several years and has been eroded by inflation. The increase in the exemption would be phased-in. The exemption would be $700,000 for estates of persons dying, or for gifts made, in 1996. The exemption would be $725,000 in 1997 and $750,000 in 1998 or later. The $750,000 exemption amount would be indexed for inflation.

Estate taxes are hurting family-owned businesses, especially smaller firms. Funds that could be retained in a business to invest in growth and create jobs are going to pay taxes on the assets of the deceased owner or the owner who desires to exit his or her firm and hand over control to the next generation. The accounting firm of Arthur Andersen estimates that the transfer taxes on business assets above the current $600,000 exemption range from 38 percent to 60 percent, depending on amount. Surviving family members frequently must sell part of the company to pay the estate taxes. According to Mr. Drew Mendoza, program director of the Family Business Center at Loyola University-Chicago, meeting this tax burden forces many family businesses into sale or foreclosure. A survey found that nine of 10 family successors' businesses failed shortly after the original owner's death, due to the difficulty of paying estate taxes. Seventy percent of all family businesses will not succeed to the second generation and only 13 percent will make it to the third generation.

According to a recent research study conducted for Massachusetts Mutual Life Insurance Company, 57 percent of owners say they intend to pass on their ownership positions to a close relative. This represents an eight percent drop-off from the 1993 study, when 65 percent of those surveyed said they intended to keep the business in the family. It is an alarming statistic, and points to a possible disturbing nationwide trend: we are losing family-owned businesses. Higher estate taxes may be the culprit or only a single factor contributing to the decline of America's family-owned businesses. These firms are important to our nation's economy. It is estimated that there are 10 to 12 million family-owned businesses nationwide. These companies may account for as much as half our gross national product and 60 percent of all wages paid.

With all the daunting challenges and obstacles already facing small business owners, the tax code should not add to the burden of family business owners by making it more difficult for them to keep their companies in family hands. We need to preserve family businesses by removing obstacles -- such as higher estate taxes -- that threaten their prospects for continued survival and success.

The last estate tax reform occurred in 1981, when the high inflation of the 1970s forced Congress to alter the existing law. The tax rate was reduced from 70 percent to 50 percent, the tax exemption was raised from $200,000 to $600,000, and further taxes were deferred on the portion of the estate the spouse inherited. These changes were only adequate for a short time. Small business owners say they have not kept pace with the state of the economy and they need to be overhauled again.

NBOA Position on Raising the Current Estate and Gift Tax Exemption

The National Business Owners Association strongly supports raising the current estate and gift tax exemption to $750,000 and adjusting it for inflation. This change will help ease the burden of estate taxes for many small business owners, keep family firms financially stable, and preserve them for generations to come.

CONCLUSION

We appreciate this opportunity to offer our views on the tax and investment incentives contained in the Job Creation and Wage Enhancement Act. These incentives will set the stage for a new American era of economic growth led by small business owners. The real growth in all major economies worldwide is coming from smaller, more entrepreneurial companies. That is especially true of the U.S. economy. The importance of entrepreneurs and small business owners to the economy cannot be underestimated. They drive the American economy, fueling its growth, adding new jobs, and creating wealth.

Congress must help unleash the entrepreneurial spirit to spur economic growth and encourage individuals with promising ideas and the courage to take risks to start and expand businesses. Too often government creates obstacles to growth -- as it has with disincentives for savings and investment. Small business owners deserve policies that promote economic growth -- policies that reward, not punish, risk-taking and hard work. The tax and investment incentives in the Contract with America are a bold and promising step in the right direction.

Mr. Chairman, we look forward to working with you and the Members of this Committee over the coming months to develop and enact the policies that will help America's nearly 22 million small business owners bring about a new American era of economic growth and prosperity.

Mr. HERGER. Thank you both for your comments.

I noted in your testimony, Ms. Kerrigan, that you did mention the importance of raising the estate tax exemption. In our Contract With America, it is raised from $600,000 to $750,000. I might note that statistically only 23 percent of family farms or businesses are able to be passed on from the parents to the children and less than 10 percent onto the third generation.

I might maybe direct my question to you, Mr. Hiatt. Do you feel that this is a concern among the small businessowners?

Mr. HIATT. Yes, sir, it is. Let me tell you why we believe it is especially important that we raise the exemption. It was raised from $200,000 to $600,000 and that gave some relief but not enough because of inflation and other things that have eroded that kind of wealth.

It is also important to note that a study has found that when small businessowners pass on their companies to their children, that because of estate taxes, 9 out of 10 of those businesses fail. It is also disturbing to note that many small businessowners are choosing not to pass on their businesses to keep them in family hands, and we think it is very important to preserve family-owned businesses. We encourage this committee to look at perhaps even raising the current threshold beyond the $750,000 limit that is proposed in the Contract.

Mr. HERGER. Thank you.

Mr. English will inquire.

Mr. ENGLISH. Thank you.

I noticed, Ms. Kerrigan, in your testimony that you would like to see us address the issue of raising the threshold for expensing of equipment for small business. Now, I know from my experience in my district, we have a lot of small manufacturers who are internationally competitive who are having to invest more or less constantly in new plants and equipment to stay competitive.

As you have polled your membership, where is this in their order of priorities, and do you think there is a long-term objective here of raising that threshold beyond even the $25,000?

Ms. KERRIGAN. Indeed. Our membership clearly supports the issue of small business expensing and concurrently increasing that level to $25,000. But unfortunately, in today's marketplace, $25,000 does not buy that much, especially if you are talking about a small or larger than small or say a small manufacturer or medium-sized business. Certainly one of the alternatives that we would support is perhaps a phase-in to a $100,000 expensing limit. We do see a need to increase that.

Mr. ENGLISH. Very good. As we have reviewed some of these proposals, obviously one of the ones that has attracted the most attention is the proposed cut in the capital gains tax, and you have offered in your testimony, I think, the most onpoint comments on the correlation between capital gains taxes and business starts.

Have you found that many of the small businesspeople starting up have to use their own resources and are deterred from finding the capital from selling assets by the existence of a capital gains tax much higher than you find in other countries?

Ms. KERRIGAN. Absolutely. If you look at where the United States stacks up internationally, we are not close to even our fiercest competitors. Many of our competitors have zero or lower rates. Even those that have higher nominal rates, Australia and the United Kingdom, at least index for capital gains and, therefore, our rate, depending on U.S. inflation, could be much higher than Australia and the United Kingdom.

The question remains, I guess, in terms of where small businesses go to seek startup capital. Since they are—since bank lending officials are scared off by such risky ventures, they do seek out venture capitalists, friends and families, and those folks have to make the determination beyond the risk of the business, are they going to sell off current assets and receive—you obviously have to pay some high capital gains tax rate on that asset versus what the return will be on investing in a business, and this is very difficult for any investor to do, even if it is a family or a friend of that person that is seeking that startup capital.

Mr. ENGLISH. You had mentioned that in other countries capital gains are indexed to inflation for tax purposes. There has been an argument here today by a number of the panelists that indexing capital gains to inflation would be a serious reduction in tax simplicity.

Now, many of your members, I would imagine, do their own tax returns. Is this a cause of concern for you?

Ms. KERRIGAN. If it was indexed to inflation?

Mr. ENGLISH. Yes.

Ms. KERRIGAN. I think this would be a positive cause for concern as opposed to—if you look at the U.S. Tax Code and what small businesses have to do to comply with, the Tax Code is absolutely a mess. I mean, there is no doubt about it, and we are definitely for making complying less complicated, less costly. I mean, if you are adding a whole series of changes to the Tax Code, then that might make a big difference, but I don't see this as being one of those major concerns.

Mr. ENGLISH. So your membership would not be concerned about the tax simplicity argument against changing the capital gains tax?

Ms. KERRIGAN. No.

Mr. ENGLISH. Finally, distributional issue, if I could just ask this last question, Mr. Chairman, let me get a quick answer from you.

There has been a lot of criticism of cutting the capital gains tax as providing tax cuts for the rich. Obviously you represent a grassroots constituency of individuals who are not affluent, who are very concerned about this issue. Would you care to comment on the equity side of this issue?

Ms. KERRIGAN. Even if reduction in capital gains did benefit the rich exclusively, which it does not, it doesn't mean that everyone else loses if you reduce the capital gains tax rate. But, you know, it is spread across a wider income spectrum than I think is reported by the media and those that oppose reducing or eliminating the capital gains.

In 1992, 56 percent of those reporting a capital gain had incomes of $50,000 or less, including the gain; 83 percent of those reporting a capital gain had incomes of $100,000 or less, including the gain. So I think there has been a misrepresentation of who will benefit and who will not.

But, you know, our position is and I think most of our small business members is that class warfare does not make for good economic policy, and so that is not a problem, you know, with our membership. And most of our small business members, I would say, make in the $30,000 to $50,000 and $60,000 range. They are not rich.

Mr. ENGLISH. Thank you very much.

Thank you, Mr. Chairman.

Mr. HERGER. Thank you very much.

Mr. McCrery will inquire.

Mr. MCCRERY. Thank you, Mr. Chairman, and thank both of our witnesses for coming and bearing with us today through a long series of testimony.

Both of your testimonies were excellent, I thought, particularly bringing home the value of some of these tax proposals to small business. Ms. Kerrigan, you have talked particularly about the importance of expensing to small businesses, and I certainly agree with your analysis.

There is one thing that I want to mention and get your thought on that I am aware of, particularly because I have an automobile manufacturing plant in my district, but I am also aware of it because a number of small businesspeople who depend on an automobile for their livelihood basically complain that they cannot expense the cost of that automobile. They can expense a tape recorder or a fax machine or, you know, all kinds of things like that, but if they don't need those things, but they have to have a car to do their business, whether it is a plumber that has to have a truck to drive to do his jobs or a door-to-door salesman that needs to have a car to keep his samples in, you know, they find that their primary business investment, as far as a depreciable asset is concerned, is an automobile, and yet they can't deduct it as they would be able to deduct other purchases of business equipment.

Would you comment on that? And do you think that is something for us, for this committee to look at as we change the rules with respect to depreciation and expensing?

Ms. KERRIGAN. Oh, indeed I do. I think that a vehicle should be a part of small business expensing. And a little known fact is that they are not, so mobile entrepreneurs, those people who use vehicles to transport themselves, their products, their goods, their services on a daily basis are not allowed to significantly expense what sometimes is their largest capital acquisition, and this occurs largely because of the luxury depreciation cap which, you know, blocks this type of expensing. So I think it would be very important for the committee to make, if they can, that tax change to make vehicles part of small business expensing.

Mr. HIATT. Mr. Chairman, could I respond to that?

I have driven from Shreveport all the way down to New Orleans. We have a lot of members in your district, and that is about a 6-hour drive depending on traffic. We have a lot of members in that area who do business in Baton Rouge and New Orleans on a daily basis, and their personal automobile is also used for business.

This is an absolutely essential component of their business and of their work, and we think that that would probably be a good proposal to look at. I think there is a potential here for abuse, but I think that can be looked at and any abuses can be mitigated against in the long run.

Mr. MCCRERY. Thank you. Also, on the question of the estate taxes, both of you have mentioned estate taxes and how that is a problem for small businesses, particularly closely held, family-owned small businesses where the heirs find that they have to sell their business in order to pay the estate taxes and therefore the business is gone, the employees who worked for the business don't have jobs, and that is a tremendous problem.

You have both said that the increase from $600,000 to $750,000 is a nice step in the right direction. Do you think that this committee should consider going further with respect to lessening the burden on heirs of owners of small businesses?

Ms. KERRIGAN. From our perspective, we think the increase is important, and we support it, and perhaps it may cover the inflation costs over the past 15 years, but we still see that even with this increase that many of these family-owned businesses that pass on the business to the next generation will probably, even with this increase, have to sell part of the family business to cover the costs of the estate tax bills.

And what this does is punishes capital accumulation and hard work, and the hard work of a lifetime of a family, so we would like to see it increase beyond the $750,000 range. I think the American Farm Bureau even, their proposal puts it up to $2 million, so an increase beyond $750,000 is indeed important.

Mr. MCCRERY. What about eliminating it?

Mr. HIATT. Eliminating it?

Mr. MCCRERY. Eliminating it, what about that? What do you think about that for small businesses?

Mr. HIATT. We could certainly support that.

Ms. KERRIGAN. We will support that, capital gains, a few other things.

Mr. HIATT. What is interesting on that very point is that a survey found that 70 percent of all family businesses will not succeed to the second generation and only 13 percent will make it to the third, and another survey found that 9 of 10 family successor businesses failed shortly after the original owner's death due to the difficulty of paying estate taxes.

So what we see is that family-owned businesses in this country are an endangered species, and if we believe that it is important to preserve the tradition of family-owned businesses that really helped build this country, then we certainly need to remove the obstacles to keep them in family hands.

Mr. MCCRERY. Thank you very much.

Mr. HERGER. Thank you very much, and thank you, Mr. McCrery, for some good questions.

Mr. Collins will inquire.

Mr. COLLINS. Thank you, Mr. Chairman.

I don't really have any questions because I fully support everything these representatives of small business have discussed. I would just like to say, though, that I am a small businessperson, I still have a small business, in fact I employ about 35 people. I consider one of the greatest stumbling blocks or competitors of my business is the U.S. Government. The Federal tax policy along with regulations pose significant barriers.

Often I feel like we are victims of the judicial system because of tort and tort actions against us as small businesspeople. We are employers and we are entrepreneurs, and I see the government using us as collectors of taxes. We do the best job for them in collecting and paying into the system, and then all too often I think we are the targets of many of those inspectors for regulatory agencies because they know that with being small, we don't have a lot of the personnel around and a lot of the wherewithal to pay for the personnel to cross every "t" and dot every "i" for us as far as our operations, especially in the area of OSHA. So I think we are often abused in that area.

Despite all those stumbling blocks we as small businesspeople, employ the majority of the people in this country. But as a small businessowner and one who often visits with many small businesses when I am back in Georgia, a common thread of thought is it just isn't worth it anymore. I am sure that you find this sentiment among the people you represent.

But, again, we appreciate you being here. We appreciate you representing the small businesses of this country and the backbone of our employment. Thank you.

And thank you, Mr. Chairman.

Mr. HERGER. Thank you, Mr. Collins.

Mr. Houghton will inquire.

Mr. HOUGHTON. Hi. I am sorry I am late. I appreciate your being willing to take my inquiry.

This session has concentrated on investment and savings and there has been an awful lot of talk about how do you churn things and how do you get benefits into usable hands so that increased investment could take place. There has also been passing references about savings, but very few concrete examples of how savings can increase.

The IRAs are a possibility, but it is not a sure thing, capital gains appear not to give any savings increase whatsoever. As far as the investment tax credit, I am not sure that is going to do the job because you can take money from overseas and bring it in rather than stimulate the savings itself.

Now our savings rate, if I understand it, is something like the 1 percent range of GDP as contrasted to, I don't know what it is in Japan, 10 to 15 percent or in Germany maybe half that or something like that. But if the savings rate is critical to everything, including investment, how do we get it up because there is no specific program I see on the shelf that is going to generate the savings we need.

If we have, for example, a gross domestic product of, let's say, $6.8 or $7 trillion, whatever it is, and you want to get it up part way to what Japan is, you have got to produce another $650 to $700 billion in savings. I don't see that coming along. I don't see that anything we have been talking about helps that process.

How do you comment on that?

Mr. HIATT. Well, I think that is the $64 million question. We think, first of all, what is important is tax policy, and this committee is expert in this regard. You can certainly influence behavior by the incentives or the lack of incentives that you put in the code.

We have seen disincentives in the code for savings investment. We think it is very important overall, and we didn't mention this in the testimony, we think that one of the most important contributions that this committee can make to savings and to overall economic growth would be an income tax cut that would, as we have seen before, helped basically jump start our economy. Several years ago such a cut created millions of jobs.

Mr. HOUGHTON. If I could just interrupt a minute. You do have the option to take that money and spend it rather than save it. There isn't the incentive, when you cut a tax, that it will go into a savings account.

Mr. HIATT. Yes, sir, and that is my point. We don't know exactly how consumers would use that. I think a great number of them, if they could, would probably put that into IRAs and to other investment vehicles, savings vehicles that we have.

I do agree with you overall that we probably have a low rate of savings in this country for several reasons. Number one is the disincentives that are in the code, but also because we have a huge public debt and a huge budget deficit that is attracting vast amounts of capital and diverting it away from savings, and we are funding this budget spending, this deficit spending that is eating up private savings in this country.

So I think the answer is we just can't deal with creating incentives for savings, we also have to deal with some of these other structural problems like the deficit, and also government spending overall and why it is diverting huge amounts of private savings, and if that is really the direction we need to go in.

I don't really know what we should do in terms of savings incentives. I like the IRA, the increased IRA provisions that are being discussed. I don't have a firm answer.

Mr. HOUGHTON. If I could interrupt just 1 minute, I would like to yield to Mr. Collins of Georgia, but before I do, I would just like to say this, that here we are trying, through the Tax Code, to help investment and savings, and I don't see us doing that as far as savings is concerned.

Mr. HIATT. I would agree with you.

Mr. HOUGHTON. You are a citizen, you both are citizens, as we are. How can you help us sink through this process. Business doesn't save, they either pay out to their stockholders or they put it into some sort of a capital investment. Lower income people don't save, so it is the middle cut, and they are not able to handle this thing.

I yield to Mr. Collins.

Ms. KERRIGAN. I would just like to make one remark.

I think some continuity in the Tax Code, and if indeed IRAs become part of this package, I mean, is that going to be a short-term thing or 4 or 5 years down the road are IRAs going to be stripped away? So if you take away sort of consistency and continuity in the entire Tax Code, then people are apt to say, well, gee, I will spend it, you know, because I don't know, you know, what tomorrow is going to bring. So I think there has to be some consistency in the Tax Code on the Federal Government's part.

Mr. HOUGHTON. Thank you.

I yield to Mr. Collins.

Mr. HERGER. I yield time to Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman, and thank the gentleman for yielding.

I just wanted to inject this thought. The purpose of tax reform or tax reduction and the purpose of the Contract With America is to leave more money in the cash flow of the private sector to stimulate the economy. When you do that, you are going to increase the bottom line of a number of small businesses as well as large businesses in this country.

When you increase the bottom lines or increase the cash flow you increase savings and investment. In my little business, if I have a few bucks left at the end of the weekly cash flow, some of those funds go into money market accounts. They are put away for when I have to withdraw to make some type of tax deposit or some type of note payment on a large note or even equipment notes. But those are funds that go into a money market savings account.

Also, a large number of businesses have pension programs or have 401(k) plans. They have something set aside for the employees whereby they contribute to and the employee contributes to. If the company's bottom line is better, they make better contributions. This is a small savings that will significantly increase the savings accounts across the country. Those are just a couple things I wanted to inject as an owner and operator of a small business today.

I thank the gentleman for yielding.

Mr. HERGER. Thank you very much, Mr. Collins.

I want to thank both our witnesses on our final panel, Ms. Kerrigan, Mr. Hiatt. As representatives of small business, I believe that you have represented them well. It never ceases to amaze, I might say, those of us who do have small business backgrounds of how we have examples of small businesspeople not being able to expense out their transportation, not being able to deduct their health insurance on themselves at a time when we are trying to encourage them to have health insurance. This is only a couple items. But, again, I do thank you very much.

And with that, this committee stands adjourned. Thank you very much. We are adjourned until 10 a.m. tomorrow.

[Whereupon, at 4:05 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, January 25, 1995.]

TAX PROVISIONS IN THE CONTRACT WITH AMERICA DESIGNED TO ENCOURAGE SAVINGS AND INVESTMENT

WEDNESDAY, JANUARY 25, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10:03 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. Today we will continue our hearings in consideration of the savings and investment provisions of the Contract With America. Yesterday, we heard from witnesses on the need to make the Tax Code less hostile to people who want to save and invest, and today's hearing is going to be devoted specifically to capital gains.

The capital gains tax cut in the Contract consists of a 50-percent deduction on all capital gains, the indexation of the basis of assets for inflation, and a capital loss deduction on the sale of a home. It is interesting that over the years the Tax Code has levied a tax on homeowners who sell their homes for a gain, but refuses to let them take any sort of a tax loss if the home is sold at a loss.

This is sort of emblematic of what has happened too often with the Federal Government, and that is heads the government wins, and tails the taxpayer loses. We want to change that. I have looked forward for a number of years to chairing a hearing of this sort because throughout my congressional career, I have taken a lead role in attempting to get capital gains taxed at a lower rate.

And I have spent years in refining the proposal that is before the committee today, particularly that of the indexing of the basis for inflation. I support a capital gains tax cut because I believe it will create jobs and more opportunities for working Americans.

Lower capital gains taxes means more capital is available to an entrepreneur who wants to start a business, to a businessman or businesswoman who wants to expand and hire more workers, to a corporation that wants to modernize its equipment to make its employees more productive so that they can be paid higher wages.

We have heard a lot about the so-called fairness issue. And I think we should talk about fairness. What is fair about taxing people on gains that are strictly due to inflation so that in the end they have less real money in their pockets than they did when they bought the capital asset? What is fair about having a lower rate for capital gains recognized by those in the higher tax brackets, but not for those that are in the 15 and 28 percent bracket? And, what is fair about a system in which you can be taxed when you sell your home with a gain, but never can deduct the loss? What is fair about a tax that punishes people who sacrifice and forgo consumption, pay the income tax on their income, take the net and invest it, save it, and then get punished by being taxed on the appreciation and value of those savings? And what is fair about a tax system that gets in the way of people who want to go out and create jobs?

I am confident that this committee will cut the capital gains tax rate this year. As a result, we will not only help people to keep and save the money that they make, we will also help America's workers find more high-paying jobs thanks to the entrepreneurs and businesses that will be able to get increased access to capital necessary for growth.

The only way that we can increase the aggregate real wages of Americans is to have higher productivity, and the only way we can have higher productivity is to continue to advance in the purchase of tools and technology to increase the output of every worker. And that is why capital savings are necessary in our society.

Those who criticize this vital tax provision would pluck the feathers off the goose that lays the golden egg. Cutting capital gains helps average Americans to get ahead and to stay ahead. Today's witnesses have been in the economic trenches and they know how hard it is to start a business and to keep it going. They know the uncertainty of making an investment and not being able to know for years whether they have been successful.

A tax code that doesn't reward entrepreneurs and long-term investors is a tax code that must be changed, so I look forward to the testimony today. Charlie, are you going to make the statement?

I recognize my colleague, Mr. Rangel for the statement for the minority.

Mr. RANGEL. Thank you, Mr. Chairman. I think this is an area that we have a bipartisan concern. You will agree that we have to concentrate on savings rather than consumption. We have to make certain that American investors are able to be competitive with foreign investors.

We also have to not rely on foreign sources of capital and to be more independent if we are really going to be leaders in the global competition. There is a serious question as to how do we score the reduction in capital gains taxes, whether we are talking about static- or whether we are talking about a dynamic-type of scoring.

The question is not what we can accomplish because of the number of our votes, it is what is going to be considered by the financial market as to whether we are cooking the books, whether we have a reliable position as it relates to the revenue question and, of course, as all of us have said, Republicans and Democrats, and it was emphasized by the President last night, we must know how we are going to pay for each and every tax—every revenue loss, rather, before we move on and do the things that all of us want to do.

And so I would like to say publicly, Mr. Chairman, that I have just been interviewed by a national newspaper and they asked how were we getting along with you, and I said that this is probably the most nonpartisan committee historically that we have on the

Hill, that we have enjoyed a mutual respect over the years and, notwithstanding the difference of political opinion we may have, that we look forward to working with these matters as other matters in a very cooperative way.

Thank you, Mr. Chairman.

Chairman ARCHER. I thank the gentleman for his statement and certainly that feeling is shared.

Any members who wish to make an opening statement in writing may submit it for the record without objection.

[The opening statement of Mr. Ramstad follows:]

OPENING STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, as we hear from today's distinguished witnesses, it is important to keep in mind how reducing the capital gains tax rate and indexing it to inflation will help all Americans.

As a recent Reader's Digest article pointed out, "In a nation built on the premise that today's poor man can be tomorrow's rich one, a high capital gains tax is neither good politics nor good economics." The article went on to quote highly respected economist Gary Robbins, who explained that the capital gains tax affects the size of the income pie, regardless of how it is divided.

We've heard about how the current high capital gains tax rate deters individuals from selling less productive assets in order to invest in others. However, some taxpayers are forced to sell because they face certain circumstances—job loss, divorce, the birth of a child—and cannot wait for a lower rate. These are not wealthy families, but they are being punished by the Federal Government for saving and investing.

As we hear from our witnesses, I hope we will all steer clear of the class-warfare rhetoric that has too often surfaced in recent months. This is a real problem, affecting real people, who have worked and saved to improve their lives. We owe it to them to take this important step to get our nation back on the right economic track.

Mr. Chairman, thank you for assembling such a distinguished panel. I look forward to their testimony.

Chairman ARCHER. Our first two witnesses today are a bipartisan panel of our own colleagues, both from the west coast, and we are pleased to have you with us today, and Hon. Ken Calvert from California is our first witness and we would be pleased to hear your testimony. The rules of the committee are that we ask that you keep your oral testimony to 5 minutes or less, and you will have permission to submit an entire written statement into the record in full without objection.

Congressman Calvert.

STATEMENT OF HON. KEN CALVERT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. CALVERT. Thank you, Mr. Chairman. And thank you for holding these hearings on the Contract With America and for giving me the opportunity to testify today on the provisions regarding the capital gains tax. I know you will hear from many people, so I will keep my remarks brief and ask that my statement be entered into the record.

In the past couple of weeks, we have heard from many taxpayers' rights groups, economists, think tanks, and businesses all advocating a reduction and indexation of the capital gains tax. They have given you the numbers and statistics supporting this, so I will refrain from repeating this data, other than to add my voice as one who knows that reducing the capital gains rate will spur economic growth, create jobs, and improve our global competitiveness.

I am not an economist or statistician theorizing on the merits of particular economic models. Before coming to Congress, I owned and operated my own businesses. My father was a small businessman who owned and operated his own restaurants. Our businesses prospered when the capital gains rate was lowered in the seventies and the eighties because it gave us an incentive to invest and expand our businesses. It encouraged expansion and growth.

Mr. Chairman, reducing the capital gains rate and indexing it to the rate of inflation is not just a campaign promise, it is just plain common sense. This is not just a tax break for the rich, this is much needed relief for the middle class small businessowners of America.

The constituents of my district, the 43d in California, are not rich billionaires who are trying to take advantage of the government. They are hard-working folks trying to achieve a bit of the American dream. They support our efforts to reduce the capital gains rate. They write and call my office and tell me to keep my promise on the Contract.

Last weekend, as most weekends, I went home to Riverside County and a constituent came up to me telling me how difficult it was to expand his business and that if Congress would fix the capital gains rate, it sure would help. A retired woman from my hometown wrote me to explain when she had been working and saved, she bought five acres of land. This property could be developed, jobs could be created, though she does need the money and realizes her property could be put to good use, she won't sell because of the current rate on capital gains.

One man from Mira Loma wrote me telling me his kids have moved out of the house, he would like to sell it and move into a smaller one, but because he is not 55 yet, he won't sell his house for fear of being taxed to death. That is just not right and it just doesn't make sense.

I am sure you have heard many other stories and these are just a few examples of what my constituents and yours, I am sure, are telling you. And it is their voice I want to share with you today. We have a historic opportunity to help these folks and I appreciate your tireless efforts, Mr. Chairman, in seeing that we succeed in these efforts.

Again, thank you very much for letting me testify.

Chairman ARCHER. Thank you, Congressman Calvert.

Our next witness is Hon. Ron Wyden from Oregon. Congressman Wyden, we would be pleased to hear your testimony.

STATEMENT OF HON. RON WYDEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. WYDEN. Thank you very much, Mr. Chairman. I thank you for this opportunity. Maybe I can spare you the filibuster this morning, and I would ask unanimous consent that my statement be put into the record.

Chairman ARCHER. Without objection.

Mr. WYDEN. Mr. Chairman, I was one of the Democrats who voted for your capital gains proposal last time out. And I have been a strong supporter of it for many years.

But I think that this Congress we have a different kind of challenge and that is to see if we can come up with an approach to addressing this capital gains issue that could bring my friend from New York, Charlie Rangel, and you as the leaders of the Ways and Means Committee together on a unified basis, and I think I have a proposal that moves us in that kind of ballpark, and let me just say for 1 minute why I think it is so important.

You know the mythology on this issue is essentially Republicans are supposed to be for a capital gains tax cut and Democrats are supposed to be against it, even though Jack Kennedy was essentially the first major proponent of a capital gains tax cut. There is this notion that the major recipients of a capital gains tax cut are Ivan Boesky or Michael Milken or something like that, but what a lot of us are seeing in our districts is it is essentially the premier growth issue for small businesses, for retired people who may have a duplex in their backyard and want to sell it and finance their retirement.

I have union workers in my State who work in a mill during the day and have a Christmas tree farm on the side, and they want to be able to get capital gains treatment for that Christmas tree farm so they can finance their youngster's college education. But we are up against this kind of mythology, and I would like to suggest a way that we could possibly bring the parties together and get my friend, Charlie, and yourself and people like me and other Republicans together on this.

I think we ought to look at treating capital gains like we do home ownership in our country. What we have said is that home ownership is special and that means that if Bill Archer sells his home in Texas and takes those proceeds and rolls them over into another home purchase, we will say the taxman will not cometh. You will not be taxed because we value home ownership.

I think we ought to look at the same sort of thing with respect to capital gains. If somebody owns a business in America and sells that business and is willing to take a portion of those proceeds and roll them over into another job-producing investment, so that Charlie could see in New York if somebody sells a business and takes a portion of those proceeds and brings them back to the community in another job-producing kind of investment, for that, we should say there should be no capital gains tax cut.

I think that something like that will allow us to incent the private sector, as you have wanted to do for so many years, and at the same time meet the kind of litmus test that many of my colleagues on the Democratic side of the aisle legitimately are concerned about. They want to see reinvestment. They want to see the private market recycle investment and earnings into job-producing sectors, and the bill that I have introduced has been cosponsored by one of your members—Congressman Matsui of California, Congressman Spratt of South Carolina has been for it as well—I think would be a beginning to try to bring the parties together on this issue, get something that the President would actually sign rather than continue this polarization on the capital gains issue, possibly get a veto.

One last point, and I see my light is on. We are very pleased that Congresswoman Dunn from the Northwest has joined your committee. She and I are cochairs of what is known as the Forestry 2000 Task Force. We are particularly interested in working with you on some growth-oriented incentives that will address the need for sustainable growth on private timberlands, very important jobs-producing issue. My statement goes into that as well and I thank you for the chance to come.

[The prepared statement follows:]

**Statement of the Honorable Ron Wyden
U.S. House of Representatives**

**Testimony before the Committee on Ways and Means
January 25, 1995**

Mr. Chairman, thank you for the opportunity to appear before the committee this morning.

Today, I want to talk about the Entrepreneurship Promotion Act, legislation I have introduced to provide targeted capital gains tax relief to boost small, fast growing, job creating companies.

These companies will be crucial components of sustained job creation in the 1990's. Small firms have consistently led America's technological charge, creating new technologies and products and high wage, high skill jobs. In my home state of Oregon, perhaps the most predominantly small business state in the country, 98% of the businesses employ fewer than 100 workers, and the state projects that fully 70% of the state's job creation in the 1990s will come from those small firms.

My legislation will create a tax rollover, similar to the one available to homeowners, to enable an investor who sold his or her stake in a qualified small business to reinvest the money in another qualified small business and defer paying taxes on the capital gain.

With this bill, investors will have an incentive to keep their money in the productive sector of the economy, rather than simply cashing out their investment. Moreover, the bill would target the incentive at investments in firms with less than $20 million in annual sales -- those companies with the fewest financing alternatives and therefore most in need of venture funds.

At some point, nearly every small business faces a crisis in finding the capital necessary to finance continued growth. Nearly every company gets caught in the awkward position of being too large to be financed internally, but not yet large enough to tap the public capital markets or adequate bank financing. Capital is the lifeblood of every small company, and without sufficient capital, an otherwise healthy small company with a great product line will be doomed to wither away.

In Oregon, for example, with its fast growing software, computer, environmental, biotech, wood products and other industries, numerous companies that could be global competitors and create thousands of jobs are at risk, simply for want of sufficient capital to fund early growth.

Let me share with the Committee a recent Oregon example. One firm, after three years and $8 million in start up funding, ran out of money just as it sought government approval for its product. According to the CEO, "No one else in the world had a comparable product, and the market was there." Thus, with no capital available, this Oregon firm went from potentially being a $40 million company to zero. I hear similar stories at home in my District on a regular basis. And I am sure, Members of this Committee have also heard this tale of lost potential, lost innovation and lost jobs.

It is imperative to pump more funds into the venture capital pipeline and to direct more of those funds to the companies that really need them. The Entrepreneurship Promotion Act is designed to do that by creating a tax incentive to get more investors involved -- and keep them involved -- in starting and growing job-creating small businesses.

There is no doubt that adequate venture capital is key to job creation. According to a Coopers and Lybrand survey, venture backed firms created more jobs and invested a greater portion of equity in research and development than the Fortune 500 companies of America between 1988 and 1992.

- Venture backed firms expanded their workforces by 19 percent a year, on average, while the Fortune 500 cut their workforces by .08 percent.

- 55 percent of the positions created by venture backed firms were skilled jobs, nearly four times the 14 percent formed in the U.S. economy overall.

- Venture backed firms invested $14,000 per employee on research and development, double the per employee expenditure of the Fortune 500 firms.

- Venture backed firms also invested more than twice as much of their revenues in plant and equipment than the Fortune 500 companies.

Venture capital has been instrumental in the development of leading edge technologies in this country. Microsoft, Intel, Genentech, Apple, Digital Equipment, Federal Express and Lotus Development all relied on venture capital financing. Today, the founders of these firms are some of America's premier venture capitalists.

My legislation is not about the search for the next Microsoft. The Entrepreneurial Promotion Act is about the other thousands of small developing firms in this country who make everything from paper bags to the newest computer games.

Mr. Chairman, there is precedent for my legislation. Specifically, the precedent is a small provision with the Omnibus Budget Reconciliation Act of 1993 allowing investors to rollover capital gains on the sale of stocks and bonds into Specialized Small Business Investment Companies or SSBIC's. My rollover proposal is similar in principle but less regulatory burdensome. Further, it will offer capital gains tax referral to a broader spectrum of businesses in the early stages of start up, development and production.

The Entrepreneurial Promotion Act will provide significant relief to those small businesses with good products and good management but are starving to death for lack of capital.

On a final note, I would urge that the Committee, in considering its broader capital gains proposal, ensure that we have a formula that encourages better forest management and more private timber production. At the moment, we have a tax code that does neither.

In Oregon, for example, we have some 22,000 small woodlot owners growing trees on approximately 3.5 million acres of woodland. This resource is quickly becoming the backbone of our timber resource in the state. Thousands of mill jobs will depend on whether these lands stay in timber production. Unfortunately, because we have removed the capital gains differential and other adjustments for inflation on an investment that takes 50 to 75 years to mature, these lands are being converted to other uses. The timber resource is being lost, forever. As a co-chairman of the Congressional Forestry 2000 Task Force -- an organization representing 150 of our colleagues -- this loss of resource in both the Northwest and the Southeast, and the tax code which encourages it, has for several congresses been our number one target for tax reform. We must remove unreasonable disincentives for critical, very long term investments like growing trees. I note that this position is supported not only by the industry, but also by all of the major environmental organizations, including the Audobon Society and the Sierra Club.

Mr. Chairman, I know the committee is taking a hard look at these issues. I do believe that your proposal for a 50 percent exclusion addresses the legitimate complaints of these timber growers very effectively.

Capital gains tax policy has been caught in fearsome partisan debate for many years. I believe it is time to move beyond old divisions and I stand ready to work with the Committee to craft job creating legislation that is good for small business, good for investors and good for the federal government.

Thank you.

Chairman ARCHER. My compliments to both of you for your testimony today.

Following up, Congressman Wyden, on what you just suggested, I have rolled this around in my own mind about whether we should eliminate any tax on a capital transaction if the money is reinvested in another capital asset. And I believe that there are a lot of constructive, positive results that could come from that.

Have you given any consideration, though, because I have thought a lot about this, to the complexity that would be involved in maintaining the records over a lifetime for each small sale of stock or mutual fund and a conversion into another capital asset?

I know that many of us have done it on our homes, but the sale of a home is probably going to occur maybe a couple of times in a lifetime and it is really not a very easy process. I know because I do my own tax return, and I know what it means to have to prepare the form that is necessary to keep up with the IRS in order to be able to trace the transactions during a lifetime when you convert from one home to another. And I just wonder if you have given any thought to that, whether that is practical.

Mr. WYDEN. I have, Mr. Chairman, and what I would say is I think that we can do this frankly in a less burdensome way than some similar approaches that are already on the books. For example, as you know, the Budget Act of 1993 essentially applied this principle to what is known as SBICs, the small business investment companies.

The bill that I have introduced with Mr. Matsui, I think, involves less bureaucracy than what we have already got on the books right now. What we are essentially saying is, look, you have 18 months to roll it over. You have to be able to show that it gets to job-producing activity.

We obviously would want to work with you all. You all are the experts, but we have consulted the Service, and I think that we could produce something in this area that would be less burdensome from a regulatory standpoint than some of the stuff that we have on the books right now. I think your committee has also done this in the real estate area as well.

Chairman ARCHER. I don't know if you paid any attention to the testimony that the committee has already received, but we had two outstanding and nationally recognized economists before our committee, and I asked them the question of whether there was a study as to what percent of capital transactions ended up being reinvested in other capital assets. They said they didn't know of a definitive study, but that they expected that it would be between 95 and 99 percent of all of the sales of capital assets. I am just wondering if that percentage is already not so high that we don't have to go into this question of exempting on rollover because the practical results are that almost every transaction does get rolled over.

Mr. WYDEN. I guess I am a little skeptical of those figures. I haven't seen the study because we have so many of our constituents pushing us for this incentive in the first place. In other words, if things were so good right now, that people were just automatically rolling things over, I kind of question why we would have everybody pushing us to get this incentive in the first place.

So I question whether that incentive is there. But what I think we really want to do is try to target something like this to the kind of job-producing agenda so that we can stand up at townhall meetings in our district. Charlie Rangel can in Harlem. I can on the west coast and say that when Congress looked at incenting the private marketplace, particularly the business sector, that we were showing that what we cared about most was reinvestment and recycling the winnings from a successful business, and I think we need to really target this in that kind of fashion.

Chairman ARCHER. Thank you.

Are there any other questions by members of the panel for these two witnesses?

Mr. RANGEL. Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Let me thank both of the witnesses, our colleagues for their contribution and Ron for your effort to bring us closer together.

I really have no problem with targeting the Tax Code so that we can encourage investments and create new jobs and jobs, as you said, that we can actually see. I think it was Rev. Jesse Jackson that said that the tide doesn't raise all boats if yours is stuck on the bottom. And I know that it takes time for these type of investments to create the incentives for people to come and the jobs will be coming.

It is just difficult for me to believe when I see the schools are not producing, the kids are on the street, the hope and dreams are not there, and there is no reason for them to be there, and then they fall into this despondency of drugs and babies and violence and crime, and, I, for the life of me, can't see how you can provide incentives for people to invest in this environment.

However, as Chairman Archer noted, I have no problem if you showed the same commitment of investing in human and intellectual capacity to be able to meet the challenges of the future, then I think that this is a marriage that we can move forward on. But it is a disgrace, as Speaker Gingrich says, when a kid can't read his diploma, when children are attending more funerals than graduations, and all I am saying is that this is a good bridge, but we have to think of ways to invest in people to make them strong enough to cross that bridge as all Americans can.

And you have made a great contribution in terms of the economic incentives, and the Speaker can join with me and others in seeing how we can get a return on our investment in people so that entrepreneurs will know that our labor force is just as good and indeed we hope better than any abroad, we are home free. And I want to thank you for your contribution.

Mr. WYDEN. Well said.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman. I would just like to put something into the record so that there is no misunderstanding about who generally files capital gains tax returns.

It is my understanding that nearly 50 percent of all returns are filed by taxpayers with less than $40,000 adjusted gross income. And nearly 60 percent of capital gains tax returns are filed by taxpayers with less than $50,000 adjusted gross income.

May I ask the two Members if that figure would put those returns, in your opinion, in the middle-income taxpayer range? Do you consider $40,000 adjusted gross income or a $50,000 adjusted gross income middle-income people in the United States?

Mr. CALVERT. Well, that is easy. Yes. I would say in California, in Southern California, $75,000 family income or less would be in the middle-income bracket.

Mr. BUNNING. I am not talking about average because now we know if we put in average income, we come down and we get an awful lot of people who are below that average, but I am talking about middle income, the workers of the day. Ron?

Mr. WYDEN. Jim, what I remember from the last time we went through this and, as I say, I was one of the Democrats who voted for Bill Archer's proposal, is that you can debate the figure whether it is $40,000 or $50,000 or $60,000, but the fact is there is an extraordinarily large number of Americans who are middle income, they are retired, they are small businesses, they are entrepreneurs trying to start a biotech company who would benefit from this.

I think we should face the fact that most Americans do not believe that, however. There is this perception in America that the capital gains issue will help, you know, somebody who is clipping coupons and working out of a highrise building in Manhattan and will not, you know, essentially be a benefit to the kind of people that you are talking about. I think it is mythology.

I think we have to deal with it, and one of the ways I think that we could deal with it is that if we could establish this tight connection between getting the capital gains tax break and in some fashion plowing it back to reinvestment, I think we can start chipping away at the mythology that I think you and I would agree on.

Mr. BUNNING. There is also a very strong statistical basis that people that are claiming a capital gain on their return will only claim it one time. In other words, they are going to be rich for 1 year. Someone who has a capital asset or has a family business or has a home, that is, someone under 55 that has a home and sells a home with a capital gain will be rich for 1 year.

Do you in your research on capital gains find that necessarily to be true or not to be true? Ken?

Mr. CALVERT. Well, in my experience with capital gains from a business perspective, if I sold a restaurant, as was mentioned earlier, more than likely somewhere down the road, I ended up buying another restaurant or if I sold a property and ended up buying another property, I think it is true that most people who invest continue to invest and grow and expand and hire folks along the way, and I think that is the important thing that we need to bring out here, that 95, 99 percent of the money is already reinvested, and to make the system more complex by having a dual capital gains rate. One based upon selling a business and transferring it to another business and it is going to just make the tax system more complex than it already is.

I think people out in the country want a system that they can understand, and I think that the tax proposal that is being brought forward to the committee is something that I think everyone can understand.

Mr. BUNNING. Joint Tax has done a study that says that generally in a 5-year period, nearly 44 percent of tax returns claim a capital gain during a 5-year period only. One time.

And I think if we update that study up until 1994, I think that would still be true because of the reluctance of people to claim a capital gain unless they are over 55 who sell homes. Thank you for your testimony. I deeply appreciate it.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman. And welcome, gentlemen. Mr. Wyden, I would like to take advantage of your background by asking you to focus us on the disincentives that exist right now in the Tax Code and what the effect of these disincentives would be unless we make changes on the critical long-term investments, like the timber industry.

Mr. WYDEN. Well, I would say that who Mr. Bunning essentially described are people who are sitting on their investments, which is really the great detriment to the American economy. What we have is a lot of people, particularly in forestry, that we would like to keep in that sector from generation to generation, but a lot of them are seeing that they can't make it any longer. They don't have those investment incentives, so instead of staying out there in the timber sector, particularly looking at managing their lands for the long term in a sustainable kind of fashion, they might say, well, let's just have a quickie sale here.

We will do it once and sell it to somebody who is going to put up a shopping center, and I think that if we really want to have families that are willing to make a long-term commitment to staying in forestry and particularly private forestry, we are going to have to incent them with some of the ideas that you have been talking about. Our staffs have been talking about the question of making sure there is expensing so that people who work on these private lands can get a writeoff when they are generating these business expenses and the capital gains tax cut.

I think if we don't have these kinds of incentives, we are going to see a lot of families say this game isn't worth the trouble and pack it in. We are going to lose the opportunity for sustainable growth in private forestry. I would also like to point out to our colleagues that the environmental community has been overwhelmingly in support of the kinds of things that we have been trying to do in terms of the capital gains incentive and expensing.

Ms. DUNN. Thank you very much. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. I want to refer to the gentleman from New York, Mr. Rangel's, comments. I have heard him make these statements and ask these questions a number of times because of his intense concern for the inner city.

I have expressed that I have a real concern for inner city, too, probably coming from a little different perspective. The gentleman from New York, I am sure, he is concerned about constituents. I, too, am concerned about constituency, a number of constituencies in the inner city for those Members who represent inner cities are on some type of government subsidy. The constituency that I represent in the Third District of Georgia are the taxpayers who are paying into the coffers that help subsidize those constituencies who are trapped in welfare.

We have a consensus among most Members of Congress that capital gains reduction would be beneficial in stimulating the economy and creating jobs. On behalf of the interests of Mr. Rangel and myself, I would like to see us focus on those inner-city areas. Perhaps zeroing out the capital gains tax in those areas as an incentive, especially for small business that would employ a number even up to 100 or 150, 200 people, encouraging those manufacturers, or entrepreneurs to go to those areas and invest.

I appreciate both of you being here. Mr. Wyden, you made a comment and I wonder if this is a declaration. You said, "I and other Republicans." Was that a declaration of coming across the aisle or was that just a figure of speech?

Mr. WYDEN. Absolutely not. I think what I want to say is Democrats and Republicans have an opportunity to work together and there has been so much mythology around this issue. Mr. Bunning talks about all the small investors that are in this. I think if we go at this thing carefully, we could come across with something that Charlie Rangel and you could both go along with that would produce that kind of inner-city investment that people could actually see and would employ our constituents.

Mr. COLLINS. Well, I think you are exactly right. This does cross all lines. I was very concerned a couple of months ago when I heard our President make a comment about low-skill, low-income jobs when we were talking and discussing the trade issue. The trade issue threatened a lot of low-income jobs, and he indicated we shouldn't worry about that because we are going to lose those jobs anyway.

I don't share that thought. I don't think we need to lose one job to any other nation. We have the wherewithal here in this country to encourage investment in all areas of this country, including the inner city. I think we should put our shoulder to the wheel and push for that type of investment with those types of jobs to help people get out of the trap that we have so gallantly put them into.

Thanks again.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. I don't think the fairness issue, if one wants to call it that, is the only issue and it may not even be a major issue. I think there are issues of fiscal responsibility, the impact of any proposed cut on the deficit and issues of growth, whether a proposed tax cut will truly promote growth.

And let me say on the first point, as we look at the capital gains tax proposal, we have to look at its projected impact on the deficit. The Republican staff suggest it will be a $56 billion loss over 5 years, the Treasury estimate is over $180 billion over 10 years.

And in terms of growth, I think we have to look at a variety of economists, and there are many both so-called conservative and so-called liberal economists who urge that a capital gains cut will not promote growth. We have to look at those views in part because in effective tax terms, capital gains already are taxed at a considerably lower rate than others.

But I want to say a word and my friend, Mr. Bunning, maybe you would listen in on this because there has been some discussion about the impact on fairness, the impact on the progressivity of the code, and let me just cite a few statistics, and this isn't mythology, just a few facts.

According to the 1991 Internal Revenue Service returns, 65 percent of the dollars realized in capital gains go to families making $100,000 or more. Those were just the facts in 1991. Sixty-five percent went to families making $100,000 or more. And also in terms of the realization for those who report every year or frequently, here are the facts from the Joint Committee on Taxation:

Sixty percent of the realizations from 1979 to 1983 went to families with incomes of $75,000 or more who reported capital gains 3, 4, or 5 years out of 5. It is true that a substantial portion of taxpayers reporting capital gains reported them only 1 year out of 5, 43.7 percent. But in terms of the realizations, those who report 1 out of 5 get a relatively small amount of the actual realizations. And I repeat, 60.7 percent from 1979 to 1983 who realized gains, realized them 3, 4, or 5 years out of 5, and these were families who had incomes of $75,000 or more and the largest bulk of that went to families with incomes greater than $200,000.

Now, I am not saying that this is the only issue. I think there are issues other than fairness, issues of the fiscal impact, fiscal integrity, and also of the impact on growth. But isn't it fair to say that it is mythology that there is an uneven impact of capital gains realizations in terms of income? There is an income distribution aspect to this that we need to consider in addition to the impact on the deficit and growth.

If I could see a very major impact on growth, and no negative impact on the deficit, then I think it would pay to have an impact, a negative impact on progressivity. But let's not deny the facts here that there is an uneven impact by income group. I would be glad to yield to my colleague.

Chairman ARCHER. The gentleman's time is expired. We have got a very, very long day today. We have got more panels, more witnesses than we have had, so I am going to invoke the rule precisely on the time or we will never get through today.

Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. Mr. Levin mentioned that capital gains are taxed at a lower rate and there is a differential when you look at it on the surface, but when you look at inflation over time in most capitals held, you know, for long periods of time, if you just keep up with inflation, I mean it can be up to an 80 percent tax on capital gains. So Mr. Levin's comments that there is already a differential in favor of capital gains, I think is fairly erroneous.

I wanted to mention this concept about somebody benefiting more than another, and that gets into this whole class warfare that we need to get away from. We need to quit talking about what is going to benefit the rich and the poor. I mean, if there is 60 percent that are getting a benefit above a certain income, that means there is 40 percent getting it below, and that means everybody is benefiting.

And the other thing we have to look at is capital gains because it creates jobs. I mean everybody benefits from creating jobs. Policies, in my opinion, and I would like to get your comments on it, that are going to benefit Americans are going to be win-win situations similar to what American management is doing now instead of having labor against management. We know we can have policies in management that benefit labor and management.

I think that we as representatives of the people of America have to look at policies that are going to benefit the rich, the poor, the young and the old, and get away from this idea of class warfare.

Mr. CALVERT. I think something that is important to bring out is that a capital gains tax, whatever that tax may be, is on top of what regular tax a normal individual will pay, so typically those who pay capital gains taxes pay more than anyone else generally in total tax paid out.

A person who makes $200,000 a year in California is paying over 50 percent of their income—of their income in tax, and then they pay a tax on their capital gains also. So there is a tremendous amount of tax being paid by those individuals who are taking up the burden of employing people and creating growth in the economy.

Mr. WYDEN. If I could respond because I think you are hitting the number one issue to actually getting this resolved. What you saw between Sandy and Jim is what has kept this issue from being resolved over the years. Sandy takes the statistics that have been produced in a number of reports that talk about, you know, wealthy people benefiting.

Jim takes the statistics that talk about the number of middle-class people that benefit. I happen to believe that Jim's numbers are better than Sandy's, but I don't think that is the way we ought to approach it.

I think what we ought to say is let's break out of both of those molds and say that the capital gains incentive should be targeted on reinvestment. Let us make a special effort to incent those people who sell a business and reinvest so that we plow those dollars back into the community and get out of this old mold of just duelling kinds of statistics.

Mr. ENSIGN. To follow up on that, I may not have followed it properly. You mentioned in your testimony about a percentage being reinvested. Is that the percentage that would avoid capital gains or do you have a percentage in your bill?

Mr. WYDEN. In my legislation we talk about the deferral applying to the portion of investment that represents new money in these qualified small businesses. But I am obviously prepared to work with all of you.

I think more than anything what I would like to see this Congress do is break that mold that you saw between the debate with Sandy and Jim and say we are going to incent the private sector. It is important, but we are going to tie it in some way to reinvestment so that our constituents can see that it goes to create jobs.

Mr. ENSIGN. You know I applaud your efforts for the reinvestment. I share Chairman Archer's feelings about that. Being a small business, and specifically a veterinarian building a new animal hospital and later selling one. It would be nice to have that for reinvestment.

I like the idea of the reinvestment, but if we can do it in a way that isn't going to make the Tax Code even that much more complex, I think it is a great idea.

Thank you, Mr. Chairman.

Chairman ARCHER. If there are no further questions? Thank you very much, gentlemen. I appreciate your testimony.

The next panel will take their seats at the witness table. Robert Johnson, James Mann, George Hatsopoulos, Mr. Hoak, and Mr. Schler.

I assume you gentlemen are aware of the operating procedure of the committee, which is that we ask you to keep your oral testimony to 5 minutes or less. Your entire written statement without objection will be inserted into the record. We are delighted to have you with us today and our first witness will be Robert Johnson, chairman and president, chief executive officer of Black Entertainment Television. Mr. Johnson, welcome to the committee. You may proceed.

STATEMENT OF ROBERT L. JOHNSON, FOUNDER AND CHIEF EXECUTIVE OFFICER, BET HOLDINGS, INC.

Mr. ROBERT JOHNSON. Thank you. Mr. Chairman, members of the House Ways and Means Committee, my name is Bob Johnson. I am the founder and chief executive officer of BET Holdings.

BET Holdings' principal business is the operations of the Black Entertainment Television Cable Network, a basic cable programming service that reaches 40 million cable households. In 1991, BET Holdings became the first black-owned company to be publicly traded on the New York Stock Exchange. From an initial investment of $500,000 in 1980, BET Holdings celebrates its 15th anniversary with a market capitalization of approximately $330 million and annual revenues in excess of $100 million.

I am pleased to have the opportunity to share my views on the question of should there be a significant change in our capital gains tax policy and the current capital gains tax rate. My response to both questions is absolutely yes. When John Malone at TCI and Jerry Levin at Time Warner invested in the idea of BET, the furthest thing from their minds was what would be the return on that investment.

In fact, when John put his first $500,000 in BET, I asked what business advice could he give me. His simple but to the point reply was, "Bob, keep your revenues up and your costs down." I followed Dr. Malone's advice and added a lot of hard work, not because I was dreaming about what the return on my sweat equity would be, but because both John and I firmly believed then and still do that if you work hard and take risks, you ought to reap the full and just reward of your efforts and initiatives.

Members of the committee, as an entrepreneur, I believe that our tax policy should encourage rather than discourage the creation and accumulation of wealth. A policy that taxes entrepreneurial gain at 28 percent, in my opinion, discourages wealth generation by hindering wealth utilization that can create additional economic opportunity and income redistribution. As a minority entrepreneur, I see the creation and accumulation of wealth as the critical component to the social and economic betterment of African-American society.

Let me share with you an alarming statistic. If you were to compare today the net worth at liquidation of the average white American household and the average black American household, you would discover a tenfold disparity in net worth, with whites at about $30,000 and blacks at about $3,000.

The primary reason for this gap is the lack of home ownership and accumulated savings among most black families. I submit that if you never own your own home, it is unlikely you will attain the basics of wealth building in this society and consequently you will never be able to pass the benefit of that to your children.

We must break this cycle. Yes, we need more better paying jobs, equal opportunity for employment advancement, and a commitment to individual initiative and responsibility. However, in my opinion, what we need more of is a fundamental belief among black Americans that we can generate wealth and accumulate wealth by combining our human and intellectual capital with available financial capital.

By changing and targeting our capital gains tax policy to make locked-up capital available to stimulate wealth creation, I am convinced we can make that belief an economic reality.

Following are my recommendations for targeting our capital gains tax policy: Target reduction to those individuals or companies that invest, either equity including stock purchase or debt in companies that are headquartered in economically depressed areas or areas designated as enterprise zones; target a reduction in capital gains to individuals or corporations that invest $25,000 in small or startup businesses. For example, when BET went public, I personally sold $6 million in stock and paid about $2 million in capital gains because I had no basis in the stock. During that same period of increased visibility, I was asked to invest various amounts in a number of startup companies that didn't qualify for bank loans.

If I had been able to reduce my capital gains tax by say 50 percent, I would have had $1 million to invest in debt or equity in startup businesses, and I believe I could have made a difference in up-and-coming entrepreneurs like myself seeking $75,000 or $100,000 to help launch their businesses.

Another point, target a capital gains tax reduction to anyone that provides a downpayment in the form of second trust financing for first-time home buyers. We have a number of people who work at BET who are able to pay the mortgage note on a home. In fact, they are paying it now for apartments, but they don't have the accumulated savings or the families don't have the savings to help them get that initial downpayment. If you could target the capital gains tax in such a way that people could use their money to put—to help young people buy their first home, I am convinced that many people would take advantage of this. And if this particular tax advantage became institutionalized by the participation of banks and mutual funds, you could see a great deal of money flowing to help black Americans obtain their first home.

I believe as a minority businessman and entrepreneur, I can use my wealth to stimulate the economy in my community, create new opportunities for individuals left out of the system far better than any government handout or subsidy.

In short and in conclusion, let the people who make the money have a direct voice in how their money is to be spent.

Thank you.

[The prepared statement follows:]

TESTIMONY OF ROBERT L. JOHNSON
BET HOLDINGS, INC.

Mr. Chairman, Members of the House Ways and Means Committee, my name is Robert Johnson. I am the Founder and Chief Executive Officer of BET Holdings, Inc.

BET Holdings' principal business is the operations of the Black Entertainment Television Cable Network, a basic cable programming service that reaches 40 million households with a mix of music, entertainment, news and public affairs programming targeted to the viewing interest of black cable subscribers. BET also owns two magazines with a combined circulation of 250,000.

In 1991, BET Holdings became the first black-owned company to be publicly traded on the New York Stock Exchange. From an initial investment of $500,000 in 1980, BET Holdings celebrates its 15th Anniversary with a market capitalization of approximately $330 million and annual revenues in excess of $100 million. I have 55 percent voting control and own 41 percent of the shares of BET. Approximately 25 percent of BET is owned by the public and BET's two original investors, TCI and Time Warner own 18 percent and 15 percent, respectively.

I am pleased to have the opportunity to share my views on the question of should there be a significant change in our capital gains tax policy and the current capital gains tax rate. My response to both questions is absolutely yes.

When John Malone at TCI and Jerry Levin at Time Warner invested in the idea of BET, the furthest thing from their minds was what would be their return on investment. In fact, when John wrote me the first check for $500,000, I asked him what business advice could he give me to protect his investment. His simple, but to the point reply, was "Bob, keep your revenues up and your costs down." I followed Dr. Malone's advice and added a lot of hard work; not because I was dreaming about what the return on my sweat equity would be, but because both John and I firmly believed then and still do that if you work hard and take risks, you ought to reap the full and just reward of your efforts and initiatives.

Members of The Committee, as an entrepreneur, I believe that our tax policy should encourage rather than discourage the creation and accumulation of wealth. It is widely quoted that African Americans comprise 12 percent of the U. S. population but have less than 1 percent of the personal net worth of our country. A policy that taxes entrepreneurial gain at 28 percent, in my opinion, discourages wealth generation by hindering wealth utilization that can create additional economic opportunity and income redistribution. As a minority entrepreneur, I see the creation and accumulation of wealth as the critical component to the social and economic betterment of the African American society.

Let me share with you an alarming statistic. If you were to compare today the net worth at liquidation of the average white American household and the average black American household, you would discover a 10-fold disparity in net worth with whites at about $30,000 and blacks at about $3,000. The primary reason for this huge gap is the lack of home ownership and accumulated savings among most black families. I submit if you never own your home, it is unlikely you will attain the basics of wealth building in this society and consequently you will never be able to distribute that benefit to your children. The end result of this failure to reach even the first rung of the American dream -- home ownership -- is having a devastating impact on the black family structure.

Let me explain. No home ownership, no home ownership deduction on income taxes and no savings on earned income. No home ownership, no ability to borrow against the equity for an education for your children. No education, no job. No quality employment, particularly for black males, a decline in the quality of black family structure. A decline in family structure, no family value system to prevent crime, teenage pregnancy, dependency and ultimately institutionalized poverty.

We must break this cycle. Yes we need more and better paying jobs, equal opportunity for employment and advancement, and a commitment to individual initiative and responsibility. However, in my opinion, what we need more is a fundamental belief among black Americans that we can generate wealth and accumulate wealth by combining our human and intellectual capital with available financial capital. Our country has been successful due to a large dose of capitalism. What better way to put capital in the hands of successful entrepreneurs than to leave it in their hands? Why "filter" such capital through the U. S. income tax system and then through the largest and most complicated budget process in the world to stimulate investment? What better way to encourage savings than to minimize and target capital gains taxation? For example, a graduated capital gains tax, say at 0 percent for the first $1 million then phased up to 50 percent of the top income tax rate would encourage investment by the vast majority of our "small" businesses in America. By changing and targeting our capital gains tax policy to make locked-up capital available to stimulate wealth creation, I am convinced that we make that belief an economic reality.

The following are my recommendations for targeting our capital gains tax policy:

(1) Target a reduction in the Capital Gains Tax to those individuals or companies that invest, either equity including stock purchase or debt in companies that are headquartered in economically depressed areas or areas designated as enterprise zones. The reduction in capital gains rate could vary according to the length of time the investment is in place and according to the amount of investment. The theory behind this proposal is that companies headquartered in economically disadvantaged areas could be made more attractive to investors due to the change in capital gains tax that will yield a higher return possibility despite the higher risk profile of these businesses, if that were indeed the case because of the location or the type of business. Start-up businesses or minority firms in these areas with limited access to capital could attract more venture capital. As capital moves into these companies, they would be able to create more jobs, increase economic opportunities and social stabilization as they choose to remain in these neighborhoods, primarily inner cities, to take advantage of this new tax policy.

(2) Target a reduction in capital gains to individuals or corporations that invest over $25,000 in small or start-up businesses. For example, when BET went public, I personally sold $6 million in stock and paid about $2 million in capital gains tax since I had no basis in the stock. During that same period of increased visibility, I was asked to invest various amounts in a number of start-up companies that didn't qualify for bank loans. If I had been able to reduce my capital gains tax, by say 50 percent, provided I invested the difference in the form of debt or equity in those businesses, I believe I could have made a difference to up-and-coming entrepreneurs seeking $75 or $150 thousand to help launch their businesses. The capital gains tax on my return, if any, on those investments should be nominal.

(3) Target a capital gains tax reduction to anyone that provides a down payment in the form of second trust financing for first-time homebuyers. The interest paid on the down payment would not be taxed, however, any gain to the investor as a result of the property's appreciation at the time of sale would be taxed at a nominal capital gains rate. Under this proposal, I believe many young black Americans who can afford to pay a sizable mortgage but have no accumulated savings for a down payment could gain access to initial financing for their first home. I am convinced that high-net worth individuals would take advantage of this targeted tax policy to help their family and friends acquire a home particularly as the program became institutionalized by the participation of banks and mutual funds. This is tax policy and social policy at its best.

My purpose in proposing these three ideas is to argue for an enlightened tax policy that can stimulate wealth creation while encouraging wealth redistribution with limited government and bureaucratic intervention.

I believe that as a minority businessman and an entrepreneur, I can use my wealth to stimulate the economy in my community, create new opportunities for individuals left out of the system far better than any government hand-out or subsidy. In short, let the people who make the money have a direct voice in how their money is to be spent.

In conclusion, a restructuring in the capital gains tax need not be a tax gift to the wealthy or a stimulant to further wealth concentration among the few. It can be and should be a clear statement to all Americans that honorable efforts at wealth generation should be rewarded and that appropriate tax incentives for savings and wealth accumulation will continue to make our economic system the envy of the world. A tax policy that encourages wealth generation and distributes widely the economic results of that behavior deserves full consideration by The House Ways and Means Committee and the Congress.

Chairman ARCHER. Thank you, Mr. Johnson.

Our next witness is James Mann, chairman and chief executive officer of SunGard Data Systems, Wayne, Pa.

Mr. Mann you may proceed.

STATEMENT OF JAMES L. MANN, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, SUNGARD DATA SYSTEMS INC., WAYNE, PA.

Mr. MANN. Thank you, Mr. Chairman and members of the committee. My name is James Mann. I am chairman and chief executive officer of SunGard Data Systems, Wayne, Pa. I am honored that you have asked me here to testify today.

In a recent issue of Fortune magazine, I was quoted on the merits of reducing the capital gains tax rate. And I said, "It is good for the economy, good for my business, and good for me."

Let me explain what I meant. Prior to 1983, SunGard was a division of Sun Oil Co. At that time, it had annual sales of $30 million and was losing money. Sun decided that SunGard was a wasteful diversion of its corporate energies and put it up for sale. Sun found no corporate buyers. So in January 1983, Sun sold the company to an investment group of venture capital firms. I joined SunGard then as president and chief operating officer and received a small equity position.

Today, 12 years later, SunGard is among the top 25 information services organizations in the United States. We are the world leader in the field of investment management software. Last year our sales reached $440 million, 15 times greater than before the venture investment. We employ 2,400 men and women, a sixfold increase since 1983. Our average compensation per employee exceeds $50,000.

We are a $40 million positive contributor to the Nation's current account. We wouldn't exist but for the tax differential on capital gains that existed in 1983.

In 1983, SunGard wasn't an auspicious place to invest any money. SunGard's growth prospects are very difficult to discern. Without venture capital investors, the parent company, Sun, would have simply closed the business and laid off its employees.

Now, even with interested venture capital investors, SunGard wouldn't have been an attractive investment had there not been an abundance of venture capital funds available. A more limited quantity of available investment funds would have compelled venture investors to seek opportunities with higher intrinsic growth potential and lower risk. It was the abundance of venture capital that allowed a surplus for the capital infusion that fueled our subsequent growth.

It is my belief that in 1983 had tax on capital gains been higher, SunGard as an independent, high-wage company would never have seen the light of day.

Now, I don't think SunGard's story is unique. We all know how important entrepreneurial growth firms have been to the American economy in the creation of jobs, national wealth, and long-term growth. But that future role is far from assured. Our current Tax Code falls hard on savings and investment, which are the keys to growth.

Little wonder that our savings and investment rate is very low compared to the rest of the world. Eliminating or significantly reducing the tax on capital gains is the best immediate way I know of to begin to address our savings and investment predicament and to release resources to cultivate a new generation of entrepreneurial firms.

Many critics of lowering the capital gains tax rate worry that such a reform wouldn't be fair. My response is that fairness is ultimately a function of individual responsibility and opportunity which is in turn a function of economic growth.

I know the phrase, "a rising tide lifts all boats," sounds hackneyed, still I have yet a better way of framing the fairness issue. If our economy doesn't sustain growth, if it didn't create high-paying jobs through the initiative of entrepreneurs, fairness is a goal forever beyond our reach.

Members of both political parties know this. A capital gains tax rate reduction is a prominent part of the Contract With America and the 1992 Democratic Party platform asserted that an expanding entrepreneurial economy is the most important family policy, urban policy, labor policy, and minority policy America can have.

I agree and, as an entrepreneur who has enjoyed some success, I can tell this committee that a lower tax rate on capital gains is a great way to begin to realize that bipartisan vision of a growing entrepreneurial American economy that is productive, creates good jobs, and maintains and improves our standard of living.

Thank you.

[The prepared statement follows:]

TESTIMONY OF JAMES L. MANN
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
SUNGARD DATA SYSTEMS INCORPORATED
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 25, 1995

Mr. Chairman and members of the Committee, my name is Jim Mann. I am Chairman and Chief Executive Officer of SunGard Data Systems, headquartered in Wayne, Pennsylvania. I am a member of the American Business Conference, an association of growth companies. I also serve as Chairman of the Information Technology Association of America, a trade association representing five thousand companies in the information technology industry.

I congratulate you for holding this hearing and I am pleased and honored that you have asked me to testify here today.

In a recent issue of FORTUNE magazine, I was quoted on the subject of capital gains taxation and, specifically, on the merits of reducing the tax rate on capital gains. In regard to reducing the capital gains tax, I said, "It's good for the economy, good for my business, and good for me." In my remarks, I would like to explain to you what I mean.

Let me begin by telling you about my company.

Prior to 1983, SunGard was a division of the Sun Oil Company. At that time, it had annual sales of about $30 million, it employed about 400 people, and it was losing money. Sun decided that SunGard was a wasteful diversion of corporate resources and energies and put it up for sale.

Sun found no corporate buyers. So, In January 1983, Sun sold SunGard to an investment group of venture capital firms. I joined SunGard as President and Chief Operating Officer and was granted a small equity position in the company.

Today, twelve years later, SunGard is among the top 25 information services organizations in the United States. We are a world leader in the field of investment management software and services.

Last year, our revenues reached $440 million (fifteen times greater than before the venture investment) with an operating income of about $70 million. We employ 2,400 men and women (a sixfold increase over 1983 employment levels) with an average compensation per employee of over $50,000.

SunGard has offices in principal cities in this country and in the world's major financial centers including London, Tokyo, Paris, Frankfurt, Stockholm, and Sydney. Approximately $40 million of our revenue comes from overseas sources making us a positive contributor to the nation's current account.

SunGard could not have done what it has done without talented and creative employees. But even with the right men and women, we would have never gotten off the ground without the then-existing tax differential on capital gains.

Keep in mind that in 1983, SunGard was not a likely place to put your money. Our growth prospects were difficult to discern. No company facing quarter-to-quarter performance pressures wanted to buy an underperforming division. Without venture capital investors, the parent company, Sun, would have simply closed the business.

Even with interested venture capital investors, SunGard would not have been an attractive investment had there not been an abundance of venture capital investment funds available. A more limited quantity of available investment funds would have steered venture investors to opportunities with higher intrinsic growth potential and lower risk. The abundance of venture capital at that time allowed patient investors to find SunGard and provide it with the capital infusion that fueled our subsequent growth.

That is why I can say that SunGard owes its existence to the comparatively favorable taxation of capital gains that prevailed in 1983 and made our company a desirable investment. It's impossible to prove a negative, but it is my belief that in 1983, had the tax on capital gains been higher, SunGard as an independent, high-wage company would never have seen the light of day.

There's nothing unique about the SunGard story; we all know how important entrepreneurial growth firms have been for the American economy in the creation of jobs, national wealth, and long-term growth. And we also know the crucial role that the entrepreneurial sector must play in the future.

But that future role is far from assured. Our current tax code falls hard on saving and investment which are the keys to growth. No wonder that our saving and investment rate is very low compared to the rest of the world. Eliminating or significantly reducing the tax on capital gains is the best immediate way I know of to begin to address our saving and investment predicament and thereby release resources to cultivate a new generation of entrepreneurial firms.

I of course know that many critics of lowering the capital gains tax rate worry that such a reform would not be fair. My response is that in the United States fairness is ultimately a function of individual opportunity which is, in turn, a function of economic growth. I suppose the phrase "a rising tide lifts all boats" is a bit of a bromide. Still, I have yet to find a better way of framing the fairness issue. If this economy does not enjoy sustained growth, if it does not create high-paying jobs through the initiative of entrepreneurs, fairness will be a goal forever beyond our reach.

To their credit, I believe members of both political parties know this. Obviously, reduction of the tax rate on capital gains is part of the Contract with America.

But it is also important to note that the 1992 Democratic Party platform asserts that an "expanding, entrepreneurial economy...is the most important family policy, urban policy, labor policy, minority policy and foreign policy America can have."

I agree, and as an entrepreneur who has enjoyed some success, I can tell this Committee that lowering the tax rate on capital gains is a good way to begin to realize the bipartisan vision of a growing, entrepreneurial American economy that is productive, creates good jobs, and maintains and improves our standard of living.

Thank you.

Chairman ARCHER. Thank you, Mr. Mann.

I am particularly pleased to welcome to the committee today a gentleman from my own home community of Houston, Tex., Mr. Hoak, who is the chairman of the Heritage Media Corp. We are delighted to have you here with us and to have a little hometown flavor from Texas, so you may proceed.

STATEMENT OF JAMES M. HOAK, CHAIRMAN, HERITAGE MEDIA CORP., AND VICE CHAIRMAN, AMERICAN BUSINESS CONFERENCE, HOUSTON, TEX.

Mr. HOAK. Thank you, Mr. Chairman. My name is Jim Hoak, and I am the chairman of Heritage Media Corp. I am also a vice chairman of the American Business Conference, a coalition of midsize growth companies. I would first like to thank you, Mr. Chairman, for holding this hearing and for the opportunity to testify before the committee.

I am speaking to you today as an entrepreneur who has started several companies over the last 25 years. I founded Heritage Communications in 1971 in Des Moines, Iowa with no employees and $1 million of risk capital. We sold Heritage Communications in 1987 for $1.6 billion. At that time, we had nearly 5,000 employees and were one of the largest companies in Iowa.

In 1987, I founded Heritage Media Corp. in Texas with equity of $5 million. All our equity is worth nearly $500 million and we have over 2,000 full-time employees and 15,000 part-time employees. During this same period of time, I have been part of the founding of several other firms, most of which have been substantial job and capital creators.

I can tell you without qualification that the driving financial incentive for creating these companies has been capital gains, and the tax on these capital gains has been very important in balancing the immediate risks of these ventures versus the longer term potential rewards.

I am currently starting another new company, an investment banking/merchant banking firm to support and encourage the development of entrepreneurial companies in Texas.

Let me tell you what you think about when you start a business. Your first thought is you have to be crazy, and all of your friends and family in relatively risk-free jobs tell you so. You then have to convince yourself that you really have got the answer and can't fail, despite the clear evidence that most new firms do fail. Is it worth it? You bet. Is it automatic? Far from it.

But it is important enough that enough Americans make this decision and take this risk in a way that ensures the continued growth of our economy and its ability to create jobs. Lowering the tax on the gains from long-term investments does change the arithmetic of decisions entrepreneurs make.

The current capital gains tax structure stagnates capital and hinders business growth. I have experienced several situations where a seller of a business avoids the high current capital gains rates by retaining his company and changing his strategy for milking the business rather than growing it. And I have seen many examples where the high rates make the cost of new growth capital too expensive for the entrepreneur to obtain.

I would like to also comment favorably upon the proposal for indexing capital gains. By itself, capital gains indexation might not be enough to stimulate investment, but it can and should be done, and I wish it had been done in 1978 when Chairman Archer first proposed it.

One of the strengths of the American society has been the fluidity between classes and income levels which is why I hate to hear a lot of the talk about which class benefits and all. Most Americans believe that they can improve themselves and their family's economic position.

The preferential capital gains tax is not a benefit only for the rich. It also benefits those people who seek the American dream. It benefits those people who are willing to take a risk for a reward. It benefits those people who create jobs and thereby benefit many others while they benefit themselves.

In the final analysis, I think that the debate about the capital gains tax is not a debate about the short term. The debate is about the future of our economic system. It is about the next generation of entrepreneurs.

I have been one of the fortunate people. I have created several companies over the last 25 years. I have definitely benefited myself and a capital gains differential has been kind to me, but I know that in pursuing my dreams, I have helped many others realize their dreams as well.

This is the context in which I view the current debate over capital gains: Simply put, do we want young Americans to have opportunities to become successful entrepreneurs and create new jobs? If so, we must provide them with sufficient financial incentive to undertake the risk and efforts starting a company demands.

Most of our trading partners, competitors have a more favorable treatment of capital gains than do we. We owe the next generation of Americans no less, an economic environment in which initiative can flourish. I don't believe that young Americans today are much different than their counterparts such as me of three decades ago. Many still dream of starting their own business or expanding existing ones.

Our obligation is to nurture their ambitions beyond the taxing stage. One necessary action is the congressional enactment of a meaningful capital gains differential. It worked for me and the many other entrepreneurs of my generation and it can work again.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF JAMES M. HOAK
CHAIRMAN, HERITAGE MEDIA CORPORATION
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 25, 1995

My name is Jim Hoak. I'm chairman of Heritage Media Corporation with headquarters in Dallas, Texas. I am a Vice Chairman of the American Business Conference, a coalition of mid-size growth companies. I would first like to thank you, Mr. Chairman, for holding this hearing and for the opportunity to testify before this Committee.

I am speaking to you today as an entrepreneur who has started several companies over the last twenty-five years. I founded Heritage Communications in 1971 in Des Moines, Iowa with no employees and $1 million of risk capital. We sold Heritage Communications in 1987 for $1.6 billion. At that time we had nearly 5,000 employees and were one of the largest companies in Iowa. In 1987, I founded Heritage Media Corporation in Dallas with equity of $5 million. Today our equity is worth nearly $500 million and we have over 2,000 full-time employees and 15,000 part-time employees. During this same period of time, I have been part of the founding of several other firms, most of which have been substantial job and capital creators.

I can tell you without qualification that the driving financial incentive for creating these companies has been capital gains, and the tax on these capital gains has been very important in balancing the immediate risks of these ventures versus the longer-term potential rewards. I am currently starting another new company -- an investment banking/merchant banking firm to support and encourage the development of entrepreneurial companies in North Texas.

Let me tell you what you think about when you start a business. Your first thought is that you have to be crazy, and all of your friends and family in relatively risk-free jobs tell you so. You then have to convince yourself that you really have got the answer and can't fail, despite the clear evidence that most new firms do fail. You find yourself betting everything on your venture, and usually come close to losing everything. There were times in both of my successful start-ups when we were within days of going under.

Is it worth it -- you bet! Is it automatic -- far from it!

But it is important that enough Americans make this decision and take this risk so as to ensure the continued growth of our economy and its ability to create jobs. Lowering the tax on the gains from long-term investments does change the arithmetic of the decisions entrepreneurs make.

Obviously, I believe that a capital gains differential is crucial to the economic future of companies like mine and to our economy. I believe that the 50% capital gains deduction which has been proposed would be very beneficial.

I have experienced several situations where a seller of a business avoids the high, current capital gains rates by retaining his company, and changing his strategy to milking the business rather than growing it. And I have seen many examples where the high rates make the cost of new growth capital too expensive for the entrepreneur to obtain.

I know that the Committee is seeking a package that will be deficit neutral, and I can tell you from a businessman's perspective that the induced growth, and incentives to save and invest, resulting from a capital gains tax cut will stimulate revenues over time and can lead to revenue neutrality. As Congressman Jim Jones said a couple of years ago, "We can enact a tax cut on capital gains that does not cut government revenues but does spur economic growth. We can do it, because we did it before -- in 1978."

I would like to also comment favorably upon the proposal for indexing capital gains. By itself, capital gains indexation might not be enough to stimulate investment. But it can and should be done, and I wish it had been done in 1978 when Chairman Archer first proposed it.

Indexation of capital gains is absolutely fair when compared with the rest of our tax structure. Harvard professor Martin Feldstein gives an example. An investor who bought a stock in 1973 for $10,000 and held it for 20 years while it earned 7.4% a year would have its value grow to $42,019. If he sold it, the 28% capital gains tax bill on the nominal $32,019 profit would be $8,965. But adjusting for inflation, the investor has actually realized only a $9,474 gain. In short, the capital gains tax consumes all but $509 of the investor's real profits -- a 95% tax! Is there any question as to why investment capital in our country is stunted, and long term, patient investing is scorned.

One of the strengths of American society has been the fluidity between classes and income levels. Unlike Great Britain with its stratified class system, most Americans believe that they can improve themselves and their families' economic position. The wealthy in this country have no guarantee that they will be so in the future. However, without incentives to invest, human nature says to the upper income levels to take the easy course -- do nothing and stagnate capital. This is a prescription for a declining economic system. On the flip-side, most of the people currently at the lower income levels feel they have the potential to achieve some wealth, and many do so over time. Certainly, the data show that movement among income groups is very strong in this country.

The preferential capital gains tax is not a benefit only for the rich. It also benefits those people who have the American Dream. It benefits those people who are willing to take a risk for a reward. It benefits those people who create jobs and thereby benefits many others while they benefit themselves.

In the final analysis, I think that the debate about the capital gains tax is not a debate about the short-term. It is not about income redistribution in the next few years. It is not even about the current budget. The debate is about the future of our economic system. It is about the next generation of entrepreneurs.

I have been one of the fortunate people. I have created several companies over the last twenty-five years. I have definitely benefited myself and a capital gains differential has been kind to me. But I know that in pursuing my dreams, I have helped many others realize their dreams as well.

This is the context in which I view the current debate over capital gains. Simply put, do we want young Americans to have opportunities to become successful entrepreneurs and create new jobs? If so, we must provide them with sufficient financial incentive to undertake the risk and effort starting a company demands.

Throughout most of this century, such financial incentives have been available. Most of our trading partners/competitors have more favorable treatment of capital gains than do we. We owe the next generation of Americans no less: an economic environment in which initiative can flourish.

Where are the entrepreneurs today who will build the job-creating companies for the next twenty to thirty years? What are they thinking about when they face the tough decision to leave their comfortable jobs and take on the risks and uncertainty of a new venture?

I don't believe that young Americans today are much different than their counterparts such as me of three decades ago. Many still dream of starting their own business or expanding existing ones. Our obligation is to nurture their ambitions beyond the talking stage. One necessary action is the Congressional enactment of a meaningful capital gains differential. It worked for me and the many other entrepreneurs of my generation. It can work again.

Chairman ARCHER. Thank you, Mr. Hoak.

Our next witness is Dr. Hatsopoulos, chairman of the board and president of Thermo Electron Corp. in Waltham, Mass.

Welcome. You may proceed, Doctor.

STATEMENT OF GEORGE N. HATSOPOULOS, PH.D., CHAIRMAN OF THE BOARD AND PRESIDENT, THERMO ELECTRON CORP., AND COCHAIRMAN, AMERICAN BUSINESS CONFERENCE, WALTHAM, MASS.

Mr. HATSOPOULOS. Mr. Chairman, I would like to thank you and your committee for inviting me. If you may recall, 2 or 3 years ago, you and I each gave a paper at a conference sponsored by the Council of Capital Formation, and I am delighted to be here in front of this committee to testify on capital gains, which I really believe has a great impact on the future of both my company and the future of the United States.

I would like to take these things in this order. First, about our company. Our company is one of the few companies that did not suffer from our past recession. In fact, throughout the recession we witnessed in the early nineties, we continued to grow in employment and sales. We never downsized anything. And our profits have been going up. In fact, this year we are completing a 10th year of record employment, sales, and earnings.

I would like to tell you how we managed to accomplish that. Ten years ago, the company adopted a very unusual strategy which has been written up in many magazines, in the Wall Street Journal and other journals. That strategy is the creation of new technologically oriented enterprises as being an important element of conducting our business. Not only do we try to grow our businesses and make them prosper, but also part of our assignment is creating new businesses. In fact, once we create a new business and reach a certain stage, we sell a minority interest to the public and retain majority control.

Actually, the parent does not sell any part of its holdings, we let the subsidiary dilute the parent somewhat by raising their own capital in the capital markets.

Currently, we have 10 subsidiaries that are publicly traded. We have never sold one share of them. They sold shares to the market to raise capital for their own growth. This has been essentially the secret of continuing to grow through bad or good economic times.

We have made a study internally to see how much of our technologies, what fraction of our technologies, have we commercialized in the last 10 years. We arrived at the conclusion that only about half of what we could have done in that time did we actually commercialize. If we had done all of them, we would now have over 20 publicly traded companies instead of 10.

The reason for the difference is very simple. In order to commercialize businesses, you need to invest at high risk. Once the business gets going, the risk declines, but initially the risk is very high and in order to attract capital which involves a high risk, you have to pay a premium.

If we had the capital gains tax treatment that exists currently in both Germany and Japan, we estimate that over the last 10 years we would have been able to commercialize a little more than twice as many businesses as we actually did.

Mr. Chairman, I would now like to turn to some macroeconomic issues because I have been a student of that field. In fact, the day that you presented your paper, I presented a paper on macroeconomic elements of the capital gains.

This country has created an enormous number of jobs over the last 20 years—in the tens of millions. In fact, there is no other country that even comes close to the ability of this country to create jobs. The problem we have had, however, is that we have created jobs that are not as high in value as those created in the past. As a result, our wages on average have stagnated.

This is exactly the issue that I tried to study in my spare time as an amateur economist. My conclusion is that we lost high value-added jobs to Germany and primarily to Japan because they have the ability to commercialize technology by taking more risks than we can. The source of that ability to take more risks is their tax system. If a Japanese person invests in government securities that are safe, they pay a tax of 50 percent.

If, on the other hand, they invest in a company that is growing, as many Japanese companies are, and there is an appreciation of their stock—generally they are not seeking dividends, but appreciation of the stock—the capital gains tax is more like 5 percent. Actually, in Germany it is zero. Hence, there are great incentives to make risky investments in new ventures.

The future prosperity and standard of living of the American people depends on our ability to create new industries. Industries that were prominent in the past have often declined because too many countries can now perform these jobs. Therefore, since we have an open world trade, there is no way that we can compete in such industries unless we pay our people low wages.

The only way we can pay our people high wages is to go into businesses where we have an advantage and that advantage is only created by taking risks. In order to take risks—to have capital available for risks—we need to equalize the burden by lowering our cost of capital. I am not talking only about venture capital, I am talking about corporations such as ours, or even General Electric, to avail themselves of capital so that they can take high risk and create new enterprises.

[The prepared statement follows:]

TESTIMONY OF GEORGE N. HATSOPOULOS
THEROMO ELECTRON CORPORATION

My name is George N. Hatsopoulos. I am President and Chairman of the Board of Thermo Electron Corporation and also Co-Chairman of the American Business Conference.

I would like to thank the Committee for holding this timely hearing on the important topic of capital gains taxation because it not only affects our businesses but, more significantly, the economic future of our country. I personally appreciate the opportunity to appear and to speak before you today on this subject.

Over the years, I have written frequently on topics in macroeconomics. I have concerned myself with issues relating to changing patterns in American savings and consumption, the cost and patience of capital, and the fiscal and budgetary roots of the decline in our long-term rate of economic growth.

I could easily demonstrate theoretically why Congress should reduce the tax on capital gains on equity investments. But the debate over capital gains will not turn on theory. A tax cut on capital gains will happen only if a sufficient number of legislators understand in real-world terms why entrepreneurs like me support a differential tax. So I would first like to frame my views from the perspective of our company, Thermo Electron.

In 1994, we completed our tenth year of record employment, sales, and profits. What set us aside from other companies is the fact that this record performance persisted throughout the recession of 1991 and 1992.

We attribute our success to the commercialization of new technologies based on ideas generated by our ongoing work in energy, the environment, and biotechnology. We identify major needs that surface in the economy and ask ourselves if we can address those needs through the appropriate application of one or another of our technologies.

If so, we create a new public subsidiary to put our ideas into action. Thermo Electron typically holds a controlling stake in the new venture and provides it with technical, managerial, and financial expertise.

Thus far, we have created twelve subsidiaries that are world leaders in businesses as diverse as the manufacture of environmental monitoring and analytical instruments, artificial hearts, cogeneration and alternative-fuel power plants, soil-remediation equipment, recycling equipment, and systems to detect explosives, drugs, and carcinogens. By spinning out our most promising new ideas into public subsidiaries, we have been able to preserve entrepreneurial discipline even as Thermo Electron itself has grown to the 309th spot in the *Fortune 500* list.

However, we have not done as well as we might have. Changes in tax policy, beginning in 1986, have made it impossible for Thermo Electron to fully commercialize all the technologies it possesses. These tax changes have effectively made the taxation of income from equity investments double that of the taxation of returns from debt-financed instruments.

Before 1986, interest income was taxed as ordinary income while capital gains were subject to a differential tax. Thus, before 1986, interest income was subject to a marginal rate of about 50 percent for the top income brackets while capital gains were taxed at 20 percent.

Tax reform in 1986 changed that. It eliminated the capital gains differential and lowered the personal tax rates. The result: capital gains and interest income were taxed at the same rate---28 percent.

It is true that the Budget Reconciliation Act of 1993 created a differential in a perverse way by raising personal tax rates on income other than capital gains However, the benefit created by the differential created was almost totally offset by the harm resulting from increased marginal tax rates.

Consider these developments from a corporate point of view. When a corporation issues debt, it can write off its interest payments. On the other hand, equity is taxed twice: first on corporate income, then either on dividend income or, for those companies that retain their earnings to grow, on capital gains By taxing capital gains at the investor level, we have, at the corporate level, raised the cost of equity relative to the cost of debt. Investors demand a higher price for their equity investments because equity income is taxed twice and capital gains receive no significant tax relief.

At Thermo Electron, we have no choice but to rely on equity to finance the commercialization of our technologies. We cannot underwrite ideas with debt---there is no collateral to balance the risk.

If, by some sort of magic, Thermo Electron were operating under the capital gains taxes that prevailed in this country in 1979, we would have generated twice the number of ventures And finally, if Thermo Electron operated with the capital gains treatment currently afforded to investors in our Japanese and German competitors, we could have enacted three times the number of new ventures.

The fact is, Thermo Electron possesses more commercially promising ideas than we can finance under the prevailing tax code. My friends in Europe know this. They often tell me that the United States is second to none in entrepreneurial and technical expertise. They wonder why our government discourages that expertise.

I have never found a good answer to their question

Let me now turn to macroeconomics issues. In the last 20 years, this country created an enormous number of new jobs. No other country even comes close to us in this respect. The problem we have is that over this period, the jobs we have created are lower value-added jobs while the number of high value-added jobs has declined. Many of the high-paying jobs we lost were in manufacturing. But we should not think that the only way to redress the situation is to recover the manufacturing jobs we used to have. That is not possible in the internationally competitive world we live in because there are too many people around the world that have learned how to perform these jobs. And many of these people are paid less than our people. On the other hand, to recapture such jobs by setting up trade barriers will deprive our consumers of lower priced products to the detriment of our national standard of living.

There is only one way to create high-paying jobs: we must create new high value-added industries. Our more advanced competitors, Japan and Germany, know that and focus on it. The United States can do even better because the entrepreneurial and technological talent that exist in this country is unparalleled.

I strongly believe that what the country needs to regain its preeminence in high-paying jobs are two things: first, an adequate amount of national saving; and second, a strong financial incentive for business to undertake new ventures in spite of risks.

Currently, U.S. national savings has fallen to less than two (2) percent of Gross Domestic Product (GDP) compared with more than eight (8) percent in the 1960s. In the long run, our current level of saving is not sufficient to maintain the standard of living of the American people, let alone increase it. Many have the impression that the sole culprit for the dramatic decline in national saving is the federal "disaving", i.e., the budget deficit. This is not so. The federal deficit accounts for only 40 percent of the decline. The remaining 60 percent is almost evenly split between the decline in personal saving and the decline in corporate saving.

It is clear to almost everyone that a direct way to increase national saving is to reduce the budget deficit. What is not so clear is how to increase private saving. Nevertheless, economics must play an important role. Under the present tax code, income used for consumption is taxed once. Income saved and invested in a noncorporate asset is also taxed on inflationary gains. Finally, income saved and invested in corporate assets is subject not only to inflationary gains, but also to corporate taxes. Such a triple taxation affects both personal willingness to save, and corporate willingness to save and invest in new businesses.

Japanese corporations reinvest earnings at twice the rate of U.S. companies because, by virtue of the prevailing capital gains differential, their stock value appreciation is taxed at a lower rate. This practice provides incentive to these corporations to undertake the commercialization of many new products, some of which are invented in the United States.

The ultimate way to redress the disincentives in our tax system to save and to create new industries is to drastically restructure the U.S. tax code and to provide total deferral of taxes until an asset is withdrawn from the national saving pool and consumed. This is the treatment that would prevail under the Nunn-Domenici tax reform or the flat tax proposal of Congressman Armey. The implementation of such a fundamental reform, however, will take several years, not only because of the needed public debate, but also because of economic necessities.

It is not prudent for us to wait for this to happen. Proposals under current examination by this Committee can and should be viewed as a necessary and consistent first step towards the achievement of broader tax reform. The capital gains initiative proposed by Chairman Archer provides an excellent case-in-point. It eliminates the tax on unreal gains resulting from inflation. More importantly, it encourages the creation of new businesses both by persons and by corporations. Thermo Electron and all of the members of the American Business Conference strongly support Mr. Archer's initiative.

Chairman ARCHER. Doctor, thank you very, very much and perhaps you can explore and develop your excellent ideas as we go into the inquiry part in a few minutes.

For the introduction of our last witness, I would recognize my colleague, Charlie Rangel.

Mr. RANGEL. Mr. Chairman, thank you for allowing me to introduce Michael Schler, who is the former chair of the tax section of the New York State Bar Association.

This committee has had a reputation of being the welfare committee for accountants, CPAs, and lawyers. And your testimony is going to be interesting because you are asking us to seek popular solutions that people may want as related to capital gains taxes and to avoid complexities that could increase fees, but also increase problems. So I thank you, Mr. Chairman.

Chairman ARCHER. Mr. Schler, I would point out that these lights in the center of the witness table will be green, yellow, and red. And when the light turns red it means your 5 minutes is up. We hope that you can keep your oral presentation within that 5-minute limit, and you may proceed.

STATEMENT OF MICHAEL L. SCHLER, FORMER CHAIR, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. SCHLER. Thank you, Mr. Chairman and Congressman Rangel. My name is Michael Schler. I am here on behalf of the tax section of the New York State Bar Association. I was the chair of the tax section until my term expired yesterday, and I continue to be a member of our executive committee.

The tax section is dedicated to furthering the public interest in a fair and equitable tax system and to the development of sound tax policy. I am also a tax partner in the New York law firm of Cravath, Swaine & Moore and have practiced tax law for over 20 years.

We are very grateful for the opportunity to present our views today. I should say we take no position on the 50 percent capital gains deduction. That raises policy issues beyond our particular expertise as tax lawyers. However, with all due respect, we strongly oppose three provisions of H.R. 9: Capital gains indexing, indexing depreciation deductions, and the imposition of new procedural requirements for the issuance of tax regulations. I would like to briefly summarize our views which are expressed in much more detail as an attachment to my statement.

I should also add that we are a completely nonpartisan group. Our executive committee has members of all political persuasions and, as far as I know, the views I am expressing are essentially unanimous among all our members.

First on capital gains indexing. We recognize the theoretical correctness of indexing capital gains to take account of inflation. However, we believe there are two fundamental problems with indexing. The first is complexity. The indexing provisions of the bill on their face add only a few simple paragraphs to the code. However, we believe that in the real world indexing will vastly increase the complexity of the tax system for everyone, including individuals, businesses of all sizes, and the IRS. Activities that are relatively simple today will involve massive calculations under indexing: Buying and improving a home, buying and selling stock or an interest in a mutual fund or investing in an IRA.

Also, if a State chooses not to allow indexing for revenue reasons, and it will certainly be costly to the States, everyone in that State will be required to keep two sets of books, one taking into account indexing and the other not taking into account indexing. Individual taxpayers are likely to be dumfounded at the prospects of two sets of books.

The other major problem we have with indexing is that we believe it will inevitably result in the return of the tax shelter days of the eighties. Every experienced tax lawyer who reads the indexing provisions of the bill immediately dreams up a half dozen ways to beat the system and create a tax shelter that eliminates tax on unrelated income.

Some of the most obvious opportunities arise from the fact that assets are indexed while liabilities are not. As a result, totally artificial tax deductions can be created with little or no out-of-pocket cost by borrowing and using the proceeds to buy an indexed asset.

Also, there would be many ways besides borrowing to create a tax shelter out of indexing. Just keep in mind the world of financial products is extraordinarily creative and very motivated to develop tax-favored investments.

I should emphasize that when you set up a system where taxpayers can get back exactly the amount of cash they put up and get a capital loss, or get back more than they put up and not be taxed, you are really opening up the floodgates for creative tax planning.

In yesterday's article in the New York Times there were some people quoted as saying that the passive loss rules that were passed in 1986 would prevent a lot of tax shelter abuses from arising as a result of indexing. I don't think that is correct because the passive loss rules don't deal with investment activity. They only deal with real estate and other business activity, so I think any tax shelter opportunities that would exist would mostly still exist despite the passive loss rules.

I would like to turn now briefly to indexing depreciation deductions under the neutral cost recovery provision of the bill. We understand that the effect of that provision is that, on a present value basis, there would be no tax on a reasonable rate of return from the use of equipment. That is another way of saying that qualified equipment is treated like a municipal bond, although the equipment has a much higher tax-free yield.

Also, if you borrow money to buy a municipal bond, the interest is not tax deductible. If you borrow money to buy equipment, the profit is tax exempt and the interest is deductible. As a result, we force an enormous boon in tax shelters. Assistant Secretary Samuels talked in his testimony about deducting the cost of equipment. He was opposed to the whole provision, but I think even he was much too kind to it when he said that the immediate deduction was like a consumption tax. With a consumption tax, you can deduct the cost of your equipment, but if you borrow to buy equipment, you cannot deduct—you do not get a net deduction, which you do under this bill.

Finally, H.R. 9 imposes new procedural requirements before a Federal agency can issue regulations. We oppose those requirements because we believe taxpayers need more regulations rather than fewer. H.R. 9 also requires tax regulations to be easily readable, written in a reasonably simple and understandable manner, not contain double negatives, confusing cross references and so on.

I don't think there is anyone anywhere who thinks the Internal Revenue Code meets those requirements, and we think the bill is an example of Congress imposing rules on other people and exempting itself from the same rules. It is completely unreasonable to expect that tax regulations can be made simple as long as the code is almost incomprehensible.

Thank you very much.

[The prepared statement and an attachment follow. Additional attachments are being retained in the committee files.]

HEARINGS ON H.R. 9 BEFORE THE HOUSE WAYS AND MEANS COMMITTEE JANUARY 25, 1995

STATEMENT BY MICHAEL L. SCHLER ON BEHALF OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION

My name is Michael Schler. I am here on behalf of the Tax Section of the New York State Bar Association. I was the Chair of the Tax Section until my term expired yesterday, and I continue to be a member of our Executive Committee. The Tax Section is dedicated to furthering the public interest in a fair and equitable tax system and to the development of sound tax policy. I am a tax partner at the New York law firm of Cravath, Swaine & Moore and have practiced tax law for over 20 years. I am accompanied by Harold Handler, a tax partner at the firm of Simpson Thacher & Bartlett. He has practiced tax law even longer and is primarily responsible for our work on indexing.

We are very grateful for the opportunity to present our views today. We strongly oppose three provisions of H.R. 9: capital gains indexing, indexing depreciation deductions, and the imposition of new procedural requirements for the issuance of tax regulations. I would like to briefly summarize our reasons.

First, capital gains indexing. We recognize the theoretical correctness of indexing capital gains to take account of inflation. However, we believe there are two fundamental problems with indexing.

The first problem is complexity. The indexing provisions of H.R. 9 on their face add only a few simple paragraphs to the Internal Revenue Code. However, we believe that in the real world indexing will vastly increase the complexity of the tax system for everyone. This includes individuals, businesses of all sizes, and the IRS. Activities that are relatively simple today will involve massive calculations under indexing--buying and improving a home, selling the family car (yes, the car is an indexed asset), buying and selling stock or an interest in a mutual fund, investing in an IRA. Also, if a state chooses not to allow indexing for revenue reasons, everyone in that state will be required to keep two sets of books. Individual taxpayers are likely to be dumbfounded at this prospect.

The other major problem we have with indexing is that it will inevitably result in the return of the tax shelter days of the 1980's. Every experienced tax lawyer who reads the indexing provisions of H.R. 9 immediately dreams up a half dozen ways to "beat the system" and create a tax shelter that eliminates tax on unrelated income. Some of the most obvious opportunities arise from the fact that assets are indexed while liabilities are not. As a result, totally artificial tax deductions can be created with little or no out-of-pocket investment, by borrowing and using the proceeds to buy an indexed asset. Also, there would be many ways besides borrowing to create a tax shelter out of indexing. Just keep in mind that the world of financial products is extraordinarily creative, and very motivated to develop tax favored investments.

I would like to turn briefly now to indexing depreciation deductions. We understand that the effect of this provision is that, on a present value basis, there will be no tax on a reasonable rate of return from the use of equipment. This is another way of saying that qualified equipment is treated like a municipal bond, although the equipment has a much higher tax-free yield. Also, if you borrow money to buy a municipal bond, the interest is not tax deductible. If you borrow money to buy equipment, the profit will be tax-exempt and the interest will be deductible. As a result, we foresee an enormous boom in tax shelters.

Finally, H.R. 9 imposes new procedural requirements before a federal agency can issue regulations. We strongly oppose the application of these requirements to tax regulations. The requirements are so burdensome that the issuance of regulations may come to a grinding halt. Taxpayers need tax regulations to be able to plan their affairs. The biggest complaint among taxpayers is there are too few regulations, not that there are too many.

H.R. 9 would also require that tax regulations be "easily readable", "written in a reasonably simple and understandable manner", and not contain any "double negatives, confusing cross references, convoluted phrasing" and so on. I do not believe there is anyone anywhere who thinks that the Internal Revenue Code itself meets any one of these requirements. H.R. 9 is an example of Congress imposing rules on other people and exempting itself from the same rules. It is completely unreasonable to expect that tax regulations can be made simple as long as the Code is almost incomprehensible.

That completes my prepared statement. I would be happy to answer any questions.

**HEARINGS ON H.R. 9 BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
JANUARY 25, 1995**

**SUPPLEMENTAL STATEMENT BY MICHAEL L. SCHLER ON BEHALF
OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION**

FEBRUARY 7, 1995

This statement supplements my statement at the January 25, 1995 hearing concerning capital gains indexing. It responds to the statement and testimony by Dr. Norman Ture, who was a later witness on the same day. Dr. Ture asserts that indexing assets but not liabilities provides the theoretically correct results, and calls "without merit" the earlier testimony by Assistant Secretary Samuels that indexing assets but not liabilities leads to tax arbitrage and tax shelter opportunities. This assertion by Dr. Ture is in effect an assertion that our prior statement is also incorrect.

For the reasons stated below, we believe that Mr. Samuels' testimony is correct and that Dr. Ture is not. Moreover, Dr. Ture's error appears to be a simple mathematical error. We do not believe this issue is an abstract economic or philosophical issue upon which there can be differences of opinion, any more than there can be any differences as to the sum of 2 plus 2.

We begin, as does Dr. Ture, with the example given by Mr. Samuels. Taxpayer T purchases land in year 1 for $100,000, giving a $20,000 cash down payment and borrowing $80,000. The land is sold several years later (assume in year 5), after there has been 30% inflation, for $130,000. Thus, the entire $30,000 of nominal profit represents an inflationary increase in the value of the property. T takes the $130,000 sale proceeds, pays off the $80,000 debt, and is left with $50,000.

Mr. Samuels points out that T started with $20,000, and to make T whole for 30% inflation it would take an additional 30% of $20,000, or $6,000, of nominal profit for a total cash proceeds (after debt repayment) of $26,000. That is, $26,000 in year 5 has the same value that $20,000 had in year 1. To the extent T receives more than $26,000 of cash in year 5, the extra cash is real profit that should be subject to tax. However, even though T receives $50,000 in cash, with basis indexation T has no tax liability on the sale because the tax basis of the asset has grown to $130,000. Thus, $24,000 of real economic profit has escaped tax.

Dr. Ture's written response to Mr. Samuels' example asserts the following:

> Notice, however, that <u>in terms of constant purchasing-power dollars, the $50,000 in cash [T] has left over after paying off the mortgage indebtedness is only $20,000, exactly the amount of [T's] original cash investment</u>. If [T] were subject to tax on the $24,000 of gain allocated by Samuels to the mortgage component of the investment, as Samuels suggests, [T] would net only $17,280. The tax would subject [T] to a net loss of $2,720 on the original investment. In fact, the arbitraging that Samuels asserts would result from indexing the basis of the asset but not the debt protects [T] from having to pay tax on a zero gain. The Treasury's complaint is without merit. (emphasis added)

The problem with Dr. Ture's analysis is the simple mathematical error in the first sentence. After 30% inflation, $20,000 will grow to $26,000, or alternatively $38,461 will grow to $50,000. In no event will 30% inflation turn $20,000 into $50,000. We believe it is indisputable that T has a true economic profit of $24,000 and should pay tax accordingly. We note that this profit is in year 5 dollars, which matches the fact that the tax on the profit would also be paid in year 5 dollars.

We would point out that the $24,000 of real economic profit that has escaped tax arises from the fact that the entire $100,000 tax basis of the asset is indexed for inflation, but no portion of the $80,000 liability is indexed. There are at least two ways of reaching the theoretically correct economic and tax results.

First, indexing could be limited to T's net investment of $20,000. This would result in an increased tax basis in the property of 30% of $20,000, or $6,000. The total tax basis would be $100,000 plus $6,000, or $106,000, and a sale for $130,000 would give rise to the economically correct taxable gain of $24,000.

Alternatively, the entire $100,000 investment as well as the $80,000 liability could be indexed. Under this approach, T would have no gain on the property (because the total sale proceeds of $130,000 in year 5 dollars has the same value as $100,000 in year 1 dollars). However, T would have an economic profit on repayment of the debt, because the year 5 dollars used by T to repay the $80,000 debt are worth less than the year 1 dollars originally borrowed by T. Given 30% inflation, the $80,000 year 1 dollars have the same value as $104,000 year 5 dollars (130% of $80,000 being $104,000). Since T is only required to repay $80,000 in year 5 dollars, T has an economic profit of $24,000 in year 5 dollars and should pay tax accordingly.

Chairman ARCHER. Mr. Schler, I can associate myself with the very last sentence since I do my own tax return, believe me. We have got a virtually arcane and impossible Tax Code in this country.

I appreciate the input of all of you. I would like to ask a question and direct it to each of you, if you would reply in turn. Assume that we are going to have a capital gains tax provision, we already have one in the current law where it is different than ordinary income and we have a 1-year holding period.

Is the 1-year holding period the optimum holding period or would you suggest a different holding period? You may start, Doctor. And then we will work to your right.

Mr. HATSOPOULOS. I believe that an ideal scheme would be to have a tax rate that does depend on a holding period and it escalates as the holding goes up. The problem with that is complexity. But there is a problem with the United States right now because a lot of corporations forgo especially risky long-term investments because their stockholders are pushing them to report earnings, and if you have a capital gains schedule where the longer you hold the lower the tax you can have the investors focus in on what the company would do, not in the next quarter, but what it would do 5 years from now. The only offsetting disadvantage of that is complexity.

Chairman ARCHER. Well, I understand that there are some who believe that we should have a sliding scale tax based on the length of the holding period, and perhaps that ought to enter into the discussion today, but, as you pointed out, it is complex.

In addition, we have had witnesses testify over the years that it creates cliffs and it affects the actual decisionmaking as to the timing for the sale of an asset and although I can understand there are advantages, there are disadvantages, but if you had to pick a holding period without a sliding scale, and have that in the law, should it be 1 year, 2 years, 3 years, 4 years, 5 years in order to qualify for a capital gains?

Mr. HATSOPOULOS. I would say 2 years, Mr. Chairman.

Chairman ARCHER. Two years.

Mr. Mann.

Mr. MANN. My focus is on venture capital because that is how SunGard was started and I believe a 1-year holding period is appropriate because no venture investment tends to mature before that.

However, I have seen some mature within 2 years, so I think that would be a bit long, and I think the sliding scale adds complexity which is undesirable—1 year would be my opinion.

Chairman ARCHER. Mr. Hoak.

Mr. HOAK. I would say that the 1 year is fine. I think that the 2 years does get a bit long, but I think that would be OK as well. I do think on the sliding scale, I think a lot of that can be taken care of through the indexation with all due respect to our last speaker.

I think that can be handled from a complexity standpoint and I think that there needs to be for long-term investment for the 20-year investment in my company, for example, that there needs to be indexation for that. I think for the typical capital gains, 1 or 2 years.

Chairman ARCHER. Mr. Johnson.

Mr. ROBERT JOHNSON. I would argue for a 1- to 2-year kind of holding period. I would also suggest that there might be other things that you might do. For example, what was critical to BET's success was not only having the investment like TCI and Time Warner, but having the chief executive in the case of TCI serving on the board. That added a bona fide kind of commitment of that company to BET's growth and development.

To the extent that you can incent companies not only to invest but to take some active role in management, at least from a board oversight level, could also contribute to a likelihood of companies succeeding from capital investment.

Chairman ARCHER. Thank you.

Mr. Schler.

Mr. SCHLER. I think a sliding scale makes things more complicated, but I have no particular view as a tax lawyer on what the right period would be.

Chairman ARCHER. So you are not of an opinion relative as to whether it ought to be 1, 2, 3, 4 or 5 years.

Mr. SCHLER. That is correct.

Chairman ARCHER. OK. Thank you very much.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. Mr. Schler, I had no idea what it was like to lose the majority here until I saw all of our staff gone. So I am going to hope that you and I can get together with the New York Bar Association so that I can get the benefit of your legal research in trying to perfect the Tax Code, and Mr. Hatsopoulos, I don't think anyone challenges your testimony. We know that we are going to have to change our way of doing business if we are going to enter this global economy. We know that things that we have been doing well, other people know how to do it just as well at a lower price.

What I don't understand and I expect Mr. Johnson to respond to this, too, that even if we were successful in providing the tax incentives for people to take more risks, accumulate the savings to make these investments so that America can continue to be in the leadership, what are we doing to prepare our work force to be partners with management in moving forward to meet these challenges? And I am not just talking about inner city.

Mr. Johnson is in a very high-tech business. It changes every day. And I know that we are doing enough research and development in the private sector, but we have universities doing pure research that could be converted so that our schooling system instead of just talking about degrees, can pump up the type of men and women that could assist in meeting these challenges.

Do we ever hear economists or people like you, Doctor, talking about this marriage between investment and intellectual abilities?

Mr. HATSOPOULOS. Mr. Rangel, I couldn't agree with you more. The issue of training people and bringing our work force up to snuff is the other side of the equation. On the other hand, let me say that currently even though we are nowhere satisfactorily training people for the jobs of tomorrow, currently we do have people that are trained, and they cannot find the high wage and high value-added jobs that they could find 5 years ago.

Mr. RANGEL. Well let me say this, Doctor, that with all of this targeting that Mr. Johnson is talking about, it is hard for me to believe, Mr. Johnson, that no matter what incentives you give people to invest in certain targeted areas, that if that community is not prepared to meet the intellectual challenges of the labor market that is necessary, no incentive is going to cause them to put their money there, no matter what returns are there.

Mr. ROBERT JOHNSON. Mr. Rangel, you are absolutely correct that capital flow is where the best return is going to be regardless, and you could do artificial things to increase the return and I think a capital gains tax lower for investments in high risk areas, can help the return and therefore make that area more attractive to capital.

Mr. RANGEL. What I am saying, Mr. Johnson, is to lower the risk in those areas so that they are not looking at a high risk area. I mean, if you listen to Treasury and listen to our government talk today as to why we have to guarantee a $40 billion loan to Mexico, it is exciting. We have to do this. Because these people have to learn higher technology in order to produce better products to increase their health, their environment, and their ability to perform so they can become consumers and continue to be one of the major trading partners of the United States, to increase our exports and therefore our revenues so that we can continue to be a leader.

Now, why can't they do that with communities in the United States?

Mr. ROBERT JOHNSON. I think, Mr. Rangel, you are absolutely right. Our company just built a $20 million corporate headquarters in Northeast Washington, D.C., one of the most difficult neighborhoods in the District to say the least. And we believe that if we had more capital investment in Black Entertainment Television in the high-tech world of programming, we can train and employ people to work in this technology.

And with the upcoming information superhighway that is going to demand a great deal of trained workers, you could see more opportunities flowing to people in this area as well as higher skills and higher paying jobs. I think the Tax Code, if used to target companies that engage in training for higher skilled jobs, can stimulate capital flow and jobs.

Mr. RANGEL. I have been fortunate to have a substantial part of my congressional district be designated as an empowerment zone where we hope to be able to bring a marriage between the business and the schools so we are not talking just about diplomas and degrees but we are talking about job opportunities.

I hope that you would share your thoughts with us as we now find a half a dozen cities that will try to see whether government can do a better job in meeting the needs of the private sector. So I will be sending you a message on that.

Mr. ROBERT JOHNSON. I would be delighted.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you. I would like to follow up with the panel on some of things that Mr. Rangel has talked about.

Les Samuels, the tax policy person for the Treasury, Assistant Secretary for Tax Policy, criticized the provisions of the Contract as not being sufficiently targeted.

I would like to ask the panel, in general, who do you think should be making the investment decisions for targeting where you invest? The Federal Government or the individual corporations or individuals who are making the investments? In other words, if we are not—if we are not sufficiently targeted, in the Contract, who should be making that decision?

Mr. ROBERT JOHNSON. I take the position that the entrepreneur, the person who has put him or herself at risk in raising capital and turning that into a business should make that decision. There is no doubt about it.

When I was starting BET, on any given day, I had my home and everything I owned mortgaged to the future of this business. And I didn't know from day to day back in the eighties when interest rates were around 14 and 15 percent and cable was in its infancy whether or not this thing would succeed or not. Well, fortunately it did.

I think coming through that crucible, I think I can sit back and look at business ideas, look at entrepreneurs, see if they have within themselves the instinct and the gut to go the distance in a very tough kind of an enterprise, that of startup businesses. Clearly I think I can do that better than any government bureaucrat or any government policy. I have done it with my business. We are doing it with other businesses.

Mr. HOAK. Mr. Bunning, I agree with that and I would add one thing more. One problem with the very specifically targeted provisions is that there is not enough faith in the business community that it will stay targeted. That is a problem with a lot of things that have been put in the past, if it is a 5-year window or whatever, and business doesn't feel it can count on the Tax Code remaining stable for 5 years and, therefore, when they are very specifically targeted, it may not produce much because we can't rely necessarily on staying there. So, therefore, I encourage you to have it be broad as it now is.

Mr. BUNNING. Thank you.

Mr. Mann.

Mr. MANN. Yes. It seems to me that most everyone can agree that investors and businessmen probably will make wiser choices on the investment of funds. Therefore, the thing that will cause those funds to be spread throughout the economy is a greater abundance of investment funds which would be provided by the differential and lower rate of capital gains taxation.

As I said in my opening remarks, SunGard was not a promising looking investment when the investment was made. But there was an abundance of investment funds and consequently there was some left over for us.

Mr. SCHLER. I would like to point out that the indexing provisions target specific kinds of assets. Only stock and tangible assets are indexed, intangible are not. That itself could create economic inefficiencies. The neutral cost recovery deduction itself gives much better tax benefits to tangible assets with a depreciable life of 10 years or less, so that is not really a neutral system in terms of different kinds of investments that taxpayers could make.

Mr. BUNNING. Quickly, can you tell me what steps we should take to increase the savings rate in this country? Quick.

Mr. HOAK. It is hard to be quick about it.

Mr. BUNNING. I know it is hard to answer quickly but I only have 5 minutes.

Mr. HATSOPOULOS. Cut the Federal deficit. Every dollar you cut from the Federal deficit increases national saving by one dollar.

Mr. BUNNING. We have every intention of doing that.

Mr. ROBERT JOHNSON. I think you put a consumption tax in place rather than taxes on income.

Mr. BUNNING. OK. Anyone else?

Mr. MANN. Consumption tax.

Mr. SCHLER. I am just a tax lawyer not an economist.

Mr. BUNNING. OK. Thank you.

Mr. HOUGHTON [presiding]. Thank you.

Now Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I want to thank all the witnesses for being here today. I want to tell you, Mr. Hoak, that you gave one of the most brilliant, poignant and articulate defenses of cutting capital gains that I have ever heard when you said that capital gains are about the next generation of entrepreneurs and that fulfilling my dreams enables many others to fulfill theirs as well.

It reminded me of a recent experience when I first ran for Congress. I was actually in the least affluent part of my district, talking about a number of subjects to a high school group. Afterward, one of the students came up to me and said he wanted to help on the campaign. And I asked him why, what was it I said that attracted him to the campaign. And he said, "I like what you said about capital gains."

I was a little bit surprised, coming from a 17-year-old high school student. And I asked him, "Do you have any capital gains?" And he said, "No, not now, Mr. Ramstad, but some day I hope to." And that is the kind of inspiration, that is the kind of incentive that we have to return to the Tax Code, and to our mindset nationally.

I would like to ask one question of Mr. Schler. I was struck by a couple of remarks you made. I am sure you agree with virtually everyone that fairness should properly be an element of the code. Do you really think it is fair for individuals who have saved and invested aftertax income in capital assets to pay taxes on the inflationary gain of that asset over the years?

Mr. SCHLER. Well, as I said, as a theoretical matter, we believe they should not. But, historically the reason for a reduced overall rate on capital gains, like the 50-percent deduction, has been that you are entitled to a lower rate because part of the gain is inflationary and so, to some extent, there is an overlap in the benefits you are getting if you reduce the rate and also index for inflation.

Mr. RAMSTAD. Well, I know we could go back and forth on this. I hope the will of the committee is somewhat different.

Let me ask you another question. Did I hear you say there are too few IRS regulations, not too many?

Mr. SCHLER. That is correct. Every taxpayer group that I know of thinks there should be more IRS regulations and they should come out quicker. The biggest problem is uncertainty in having this very complicated Tax Code.

Mr. RAMSTAD. Excuse me for interrupting. Who said that?

Mr. SCHLER. We have TEI, the Tax Executives Institute, and the American Bar Association. As far as I know every taxpayer group has asked for more regulations rather than fewer. There was also a GAO report in the last few weeks that did a survey of taxpayers and came to the same conclusion.

The problem is that Congress enacts these very complicated statutes and generally delegates all the hard areas to the IRS to solve by regulation, and then taxpayers are faced with this enormous uncertainty. They just don't know how to do their transactions because they don't know what the tax rules are, and they beg the IRS to put out rules.

It doesn't matter so much how they come out, just so people know what the rules are. The burden of uncertainty is really a drag on the economy and I believe pretty much all taxpayer groups believe the same way.

Mr. RAMSTAD. Let me ask the entrepreneurs, any of the entrepreneurs on the panel to respond to that.

Mr. HATSOPOULOS. Obviously the tax rules are so complex that in fact corporations spend a lot of resources in dealing with the Tax Code. There is no question about it. Those resources could be better spent developing products or selling those products.

Mr. RAMSTAD. I see the yellow light coming on. Let me ask the four, with all respect, the four entrepreneurs to Mr. Schler's left, certainly not ideologically speaking, but if there is any of you who agree that IRS regulations are too few in number.

Mr. ROBERT JOHNSON. Let me try to point out what I think Mr. Schler is saying. For example, we deliver our programming signal by a satellite transponder. The transponder is located 22,000 miles in the sky above the equator. Now, where is it taxed? Is it taxed in the jurisdiction where the company is headquartered? Is it taxed in all of the areas where we deliver the signal? Where do we pay the—how do we handle that asset?

It is when you don't have rules—I think what he is saying—that he would rather—best of all worlds from an entrepreneurial standpoint would have probably been no tax, but since you are not going to get to that world, the best would be, from any business point, certainty is always better than uncertainty. And I think what he is saying out of frustration, we want certainty since we can't have a flat no tax base.

Mr. RAMSTAD. Don't give up on that yet. I see my time is up.

Thank you, Mr. Chairman.

Mr. HOUGHTON. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

I find the testimony interesting. I guess I might have been an entrepreneur many years ago, but I can't remember, it was so long ago. But I want to test your memory a little bit. Mr. Johnson, BET was organized when?

Mr. ROBERT JOHNSON. 1980. January 25, 1980.

Mr. STARK. 1980. OK. And Mr. Hoak, you had a major transaction sometime around 1987. You sold a company in Iowa?

Mr. HOAK. Yes. Started in 1971, 1970, and sold in 1987.

Mr. STARK. So you started in 1970. Nineteen-seventy-one was when you first dipped into the entrepreneurial waters?

Mr. HOAK. That is correct.

Mr. STARK. And Mr. Mann, when did you emerge on the scene as an entrepreneur.

Mr. MANN. Well, I emerged more than once. This time in 1983, when SunGard was founded by the investment group.

Mr. STARK. But you had been an entrepreneur before that.

Mr. MANN. Yes, that is correct.

Mr. STARK. When was your first startup?

Mr. MANN. It is very embarrassing to make me admit this in a public forum, but it was 1966 or 1967.

Mr. STARK. OK. Now I guess I am going to ask you what the marginal capital gains rate was in 1968, let's say?

Mr. MANN. I don't remember what it was in 1968. I remember what it was, however, in 1983. It was 20 percent.

Mr. HOAK. I remember——

Mr. STARK. I will tell you it was 26.9 percent. Mr. Hoak, do you remember?

Mr. HOAK. I do remember. I have to admit I went back and checked it before this hearing, but the interesting thing then was——

Mr. STARK. What was the rate?

Mr. HOAK Thirty percent.

Mr. STARK. You were a little high. Maybe only 28.

Mr. HOAK. But there was a 40 percent differential at that time.

Mr. STARK. Mr. Johnson, do you remember what yours was?

Mr. ROBERT JOHNSON. No, I didn't focus on that.

Mr. STARK. It was about 28 percent.

My point is, and I didn't remember either, that I started in 1961 when it was higher than any of you guys can imagine. With the California marginal rate added in it was probably 47 percent. You guys couldn't pay that much tax if you paid it twice now.

Now, what I am suggesting is that for an entrepreneur and somebody who is going to start up a business and get going, the last thing you think about is what you are going to pay 5 or 1 or 10 years in the future in capital gains.

Gentlemen, the point is, when you got an idea or a chance to get off on your own, you do it. Mr. Johnson, I know that you had an opportunity that was created by a whole confluence of happenstances and you would have grabbed that chance, I am sure, if the capital gains rate had been 60 percent, because it was a great business that was just waiting to get started. I don't know as much about how all of you did.

So while one of the problems that we have is if we are going to drop it under Mr. Archer's proposal to 18 percent, sure that is 10 percent less than you might pay on the margin today, that is going to cost the government at some point in time some money. There is a debate as to how much it will be and I am just wondering if it is going to really stop people. I always think that entrepreneurs are born, not made; and I have a hunch that we are going to see entrepreneurs continue regardless of what we do with the capital gains tax.

I don't mean to pinch you into a corner on this, but are there other areas, and I have a hunch there are efforts in terms of regulation, having nothing to do with the Tax Code, that would keep you from going into a business more than future taxes.

Go ahead, Mr. Johnson, I am sorry.

Mr. ROBERT JOHNSON. Let me respond to that. I stated clearly in my testimony that the furthest thing from my mind and the furthest thing from the investors' minds was what was going to be the return on the equity. It was really this was a great idea and it was an exciting thing to do.

But having said that, when you get to the point where you do have a return and you look back on what you have accomplished, why shouldn't you have the full benefit and fruits of that hard work?

Mr. STARK. I am with you. When I sold my business and came to Congress, I told you I paid 47.5 percent, and if Mr. Archer will make this tax retroactive to 1973, I will be right there with him.

Mr. ROBERT JOHNSON. I paid 28 percent in Federal and 10 percent in the District of Columbia, so I am at 38 percent, so I understand that. The point I am making, though, is with the difference I would have under Mr. Archer's proposal, I believe that instead of being 1 BET, there might be 2 or 3 or 4 or 5 other kinds of companies employing 450 people like I do, because I think I can better deploy the dollars than the $2 million I sent to the D.C. government, and to the Federal Government. I don't know what they did with it, but I do know that there are a lot of guys out there right now looking to me to put $200,000 or $300,000 in their business.

Mr. STARK. If the Chair will indulge me for a final comment, and I understand exactly what you are saying, but I think you would find as we look at the availability of venture capital, particularly from the venture capital funds and there have been lean years and there have been some years when there has been $5 of venture capital for every decent startup available. And I don't think that has had any relationship to the capital gains tax. That has a relation as to whether the major pension funds have been intrigued by diversifying into capital gains. Though when they haven't, I think that in this case you have to make sure that you will get a bigger pool of venture capital by cutting the capital gains tax, and I am not sure that the panel has made that or that we have the economic information to make it.

Thank you, Mr. Chairman.

Mr. HOUGHTON. Thank you.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

I just would like to respond to Mr. Stark. He may be one of those venture capitalists or those entrepreneurs, rather, who was born rather than made, but in my experience as an attorney working on venture capital matters with a large corporation which could have invested its money in any number of activities, the amount of the return on a capital investment that you get to keep has a lot to do with how you invest your money. And I think it is just a matter of rationality.

I want to point out that much of what I know about tax law and tax shelters I learned at Mr. Schler's law firm. I was an associate at Cravath, Swaine & Moore, and I have a great respect for the capabilities of its tax department. I spent a lot of time doing tax shelter work, leverage leasing of every asset known to man and some that I didn't know existed until I worked on the papers.

But I do disagree with your conclusions as to the desirability of indexation. You have told Mr. Ramstad, Mr. Schler, that in the abstract, it is not fair to impose a tax on a gain that reflects solely the impact of inflation.

Let me ask you whether you think it is appropriate, it is a legitimate feature of the Tax Code to deduct the cost of interest borrowed to purchase an asset.

Mr. SCHLER. Well, if the interest is paid on a loan to purchase an investment asset, yes, because that goes into your calculation of your net income. If the interest is for a personal asset, it is not deductible now unless it is mortgage interest and I think it probably should not be.

Let me just add one other thing. The entire Tax Code is really a tradeoff between what is theoretically accurate and what is administrable. And if we want to be theoretically accurate, every time somebody buys some foreign currency travelers checks and goes to Europe and cashes them, they are going to have gain or loss because the currency rates have changed in the meantime.

You just can't administer a system that is accurate to every last penny. You have to have some overall simplifications in order to have an administrable system. And the more you get into things like indexing, even though we all admit it is theoretically accurate, the more unadministrable the whole code just becomes.

Mr. ZIMMER. Well, you just conceded that at least interest incurred for investment is a legitimate tax deduction and, previously, you conceded that it is not fair to tax a gain that is solely the result of inflation, but you are attacking the combination of those two factors as some kind of unjust enrichment of the investor, an unjustified tax shelter.

How do you explain that?

Mr. SCHLER. Let me give you an example. Let's say you use $100 to buy an asset and sell it for $110, and that is because of 10 percent inflation. Since you end up with exactly the same value of cash that you started with since $110, after 2 years, say, is worth exactly the same as the $100 that you started with, as a theoretical matter, I would agree you should not be taxed on that gain because you end up with the same net worth you started with.

On the other hand, if you borrow $100 to buy an asset, you haven't laid out any money at all. Assume you sell the asset after the same 2 years for $110 and use the $110 to pay off your loan, $100 of principal and $10 of interest. You start with no cash and you end with no cash, and you get to index the basis of the asset for inflation. In this transaction, there was absolutely no out-of-pocket to you at the beginning and no cash at the end. Nevertheless, you get—you would get a higher tax basis in the asset.

If there is 10 percent inflation in that period, you would have a tax basis of $110, you would have no gain when you sold the asset. You also get a $10 interest deduction, and so you end up with a net tax benefit which would shelter other unrelated investment income that you have. I don't know of any theoretical justification for a tax benefit from a transaction that you broke even on.

Mr. ZIMMER. I would like to pursue that further but the yellow light is on. I have one quick question.

Do you believe it would enhance the simplicity of the Tax Code to reduce the capital gains rate to zero?

Mr. SCHLER. It would enhance it even more to eliminate the income tax altogether.

Mr. ZIMMER. Could you answer my question.

Mr. SCHLER. But the answer to your question, I suppose, no, it would not because you would have all the same distinctions people used to have to make on distinguishing capital gains from ordinary income.

Mr. ZIMMER. We already do, don't we, because of the differential?

Mr. SCHLER. The greater the difference in rates, the more pressure there is and the more tax shelters. Also, the further you reduce the rate, the bigger the tax shelter you get from the interest deduction from the borrowing to buy the asset that gives rise to the reduced tax on the sale. So the lower the capital gains rate, the more you are going to allow taxpayers to keep a lot of interest deductions, allowing people to shelter more and more other income on one of these leveraged transactions.

Mr. ZIMMER. Thank you.

Mr. HOUGHTON. Mr. Johnson will inquire.

Mr. JOHNSON OF TEXAS. No questions, Mr. Chairman.

Mr. HOUGHTON. Ms. Dunn.

Ms. DUNN. No questions.

Mr. HOUGHTON. Mr. Collins.

Mr. COLLINS. No questions.

Mr. HOUGHTON. Mr. Portman, do you have any?

Mr. PORTMAN. Thank you, Mr. Chairman.

Just briefly, I don't want to lose this opportunity to talk to people who in the real world are entrepreneurs, and I am sorry my former entrepreneur colleague has left because I really wanted to give you a chance, the four of you, to respond to his question which took practically his entire time. So if you could think back to the point he was making with regard to what is the incentive to invest in a startup enterprise, I would appreciate your response to that.

Also, I would like you to be thinking about a question that I have. If you had a choice between indexing and a reduction of, say, 50 percent in the capital gains rate on the one hand and then a third option which would be reducing individual rates overall and perhaps corporate rates, how would you gauge those?

First, respond to Mr. Stark's statement.

Mr. HOAK. Responding to Mr. Stark's statement first, I think that he is wrong in his conclusion. I think it is possible or it is likely that entrepreneurs on average would still begin businesses, but we are dealing at the margin and I think that it is the extra investments, as Bob talked about, that can create a larger savings and larger capital formation group in this country.

Also, he is looking only at the entrepreneur. He is forgetting that the outside capital sources, and I can say absolutely that in the late seventies when the capital gains rate went down, capital was much easier to attract to my company. Therefore, we had a tremendous growth spurt because of that. So the outside investors, as was indicated over here, do absolutely look at the aftertax return and maybe the entrepreneur plows forward because of a dream in some cases but not all.

As far as your choice, if I can just quickly, I would take the cut in the capital gains rate and the indexation. Even though I would dearly love to see also a reduction in the individual rates, I think it is important for capital formation in this country that we have a large differential. And the reduction in 1984 bringing everything down to 28 percent, while attractive in some ways, I think did hurt capital formation in the country.

Mr. PORTMAN. Thank you.

Mr. Mann.

Mr. MANN. Yes. I think there will always be entrepreneurs, but common sense kind of tells me that there will be more, the more incentive there is for entrepreneurship. And also, Congressman Stark's analysis didn't take into account that sometimes an entrepreneur is unable to start a business with his own money. He needs outside sources of money which sometimes comes from friends, relatives.

But in today's complex world, it comes in large part from professional venture investors, and professional venture investors are certainly motivated by the advantage that the tax reduction on capital gains gives to a venture investment compared to the other forms of investment that they could make. And in that case, I think, also, it makes sense that the more venture funds available to entrepreneurs, the more they are going to invest and the greater the rewards for venture investments, the more funds will be available.

Mr. PORTMAN. Dr. Hatsopoulos.

Mr. HATSOPOULOS. Well, I am a little disturbed with the course this discussion is taking for the following reason. People in America feel that the main source for new business creation, which is very important to maintain our high standard of living, is new startups.

Now, there is no question it is an important source, but virtually none of the businesses that start with technology in Japan and by which Japan competes with this country, were new startups. They were businesses started within major corporations.

The problem in America is that there is a tremendous ability of U.S. corporations to start new businesses, to go in new directions the way Yamaha does, the way Sony does, the way many of the other Japanese companies do. Few of them do. Why? Has anybody asked the question why all the enormous resources and capital that exists in U.S. companies don't go into creating new businesses?

Why do we have to sell them to the Japanese? I have studied this issue for 10 years. The answer is that there is tremendous pressure for American companies to produce results now.

In our company we have invested in a major enterprise that took us 26 years, that is an artificial heart, we just came out with it. I don't think there is another major corporation that would ever come close to this because the investment in R&D and intangible investments, which is what that takes, are not capitalized, they are expensed. And, therefore, nobody notices it, the stockholders don't notice it. This is a major problem we have and nobody talks about it.

Mr. PORTMAN. Dr. Hatsopoulos, you had made the point previously that the capital gains differential will assist in a longer term investment strategy by businesses. Is that your view?

Mr. HATSOPOULOS. Let me give you—if I may.

Mr. PORTMAN. Mr. Johnson.

Mr. ROBERT JOHNSON. I didn't get to the earlier question.

Mr. HOUGHTON. Can you make it quickly.

Mr. HATSOPOULOS. I would like to point out that the Japanese corporations pay less than a half of their earnings—the fraction of earnings that we pay in America. These are nationally available data. The reason is that their investors don't want dividends. They want their companies to reinvest their earnings to get growth so that the leverage that you get in Japan is in a completely different fashion than what we have been discussing right here and that is a major source of growth that is completely dismissed in this country.

Mr. PORTMAN. Mr. Johnson.

Mr. ROBERT JOHNSON. To Congressman Stark's point, I think the one thing he forgot is that capital doesn't flow to every segment of this society on an equal basis, and the biggest problem for minority startups and entrepreneurs is lack of available capital, access to capital. So you need the kinds of incentives, the kinds of targets that I talked about to get capital to flow.

An inducement you can give by reducing the amount of capital gains on whatever investment you might make in these businesses is going to be helpful to encourage the flow of capital.

Mr. HOUGHTON. Thank you very much, Mr. Johnson.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Schler, I enjoyed your testimony. It was a powerful green-eyeshade sort of a presentation which, as a former municipal internal auditor, appealed to me on kind of a primal level.

Mr. SCHLER. I will take what I can get.

Mr. ENGLISH. I was curious, though, yesterday we heard testimony from a number of people representing small business organizations to whom I posed the question: Was the question of tax complexity a serious argument for them and for their membership against indexing capital gains? And these are generally people who would prefer to do their own tax returns, who don't like accountants, who hate lawyers.

And I wonder, in view of the fact that they strongly feel that capital gains should still be indexed, even if it makes the business of filling out a tax return more complicated, is the loss of tax simplicity really more important than the incentive effect and the unlocking effect of a capital gains cut and indexing capital gains?

Mr. SCHLER. Well, I cannot speak to the incentive or unlocking effects because that is really an economic question rather than a technical tax question.

Mr. ENGLISH. Sure.

Mr. SCHLER. But I really do think that indexing will be more complicated than people may realize in theory. It only takes up a few pages of the bill and people might think that indexing—anything you can add in 2 pages to the code can't add too much to the tax return, but it is really not true.

If somebody buys an interest in a mutual fund and holds it for 10 years, there are going to be 40 calculations for indexing. If you buy stock, and invest in a dividend reinvestment plan, every time there is a dividend that gets reinvested, you get a new holding period.

Every time you make a gift, the recipient of the gift today has to know the tax basis, the original cost, of the property that was gifted. Under indexing they are going to have to know what the original purchase date was to the calendar quarter. And it is a really—it is a very all-pervasive kind of change in the rules that people are used to. I am really not sure people would support indexing if they sat down and realized on a line-by-line basis on the tax return just what it is going to do.

Mr. ENGLISH. OK. I guess the point being, that the ultimate users of the tax system, the taxpayers, if they are supportive of slightly more tax complexity under these circumstances, maybe that ought to be the overriding concern. But let me follow up, you made a similar argument against the neutral cost recovery system in that it would add to the complexity.

At the same time, we have heard testimony, again on previous panels, that investment in plant and equipment is a critical catalyst to economic growth and development particularly with small, internationally competitive manufacturing firms that make up a good bit of the employment base in places like my district and that perhaps this sort of investment, specifically in equipment, is the biggest factor in economic growth and development right now in our economy.

I wonder if you find the Nickles system troublesome from a complexity standpoint. Can you suggest some tax incentives for capital investment that would be acceptable from your standpoint. I noticed in your testimony you didn't really get into that.

Mr. SCHLER. As I said before, we are tax lawyers and we really have not studied alternatives. I do think that system is very complicated because it is an elective system and because it has lower depreciation in the early years than people are entitled to today. You get all the benefits in the later years.

If you are going to sell your equipment within a few years, you are better off not being under the new system as you get faster depreciation under the current rules. So every time you buy a piece of equipment, you have to make an election as to which system you want to be under. To do that, you have to figure out how long you think you are going to hold the equipment. And if you are wrong, you end up worse off than if you had made the other election. I think that itself is going to add vast complexity into the system.

Mr. ENGLISH. I understand that. I guess my concern is, the current tax law is biased against that sort of capital investment. I think we need, accordingly, to change that law and hopefully do it with some conformance with the general concerns and principles you have raised.

I don't have a lot of time left, but I would like to throw to the panel, generally, we have heard a lot of criticism of the capital gains tax cut. We have heard from the standpoint of the equity. We have heard from a number of people in yesterday's panels about the king for a day effect, a lot of the middle-class taxpayers are a one time only payer of capital gains.

But I wonder if there isn't a substantial middle-class stake in a capital gains tax in terms of the growth and opportunities that arise. And, you know, I would be happy to have Dr. Hatsopoulos respond.

My time has expired, but respond briefly.

Mr. HATSOPOULOS. Mr. English, your question was whether there is a middle-class——

Mr. ENGLISH. Whether working families, whether American workers don't have a stake in the economic growth and opportunity that is going to arise from the unlocking of this and reinvestment of this capital.

Mr. HATSOPOULOS. They probably are going to have a direct—not only indirect, but direct benefit. First of all, a lot of people that are making between, say, $45,000 and $90,000 have stock options. These people do. All of our employees have a stock purchase plan. They all avail themselves of that stock purchase plan. The stock they buy, they have to hold for 1 year. And they do that.

Eighty-five percent of our employees are in our stock purchase plan, and some of them earn less than $45,000. Maybe $30,000. Some of the assistants—my Secretary—are participating. I know. My secretary has consistently. So I think that there are a lot of individuals that would be very supportive of a lower capital gains tax.

Let me tell you, in my own company——

Chairman ARCHER [presiding]. The gentleman's time has expired.

Mr. ENGLISH. Thank you, Mr. Chairman.

Chairman ARCHER. I believe that all of the panelists have been questioned at this point. Gentlemen, you have made a great contribution by coming and giving us your testimony and responding to questions. We are very grateful to you. We wish you Godspeed.

We are prepared to hear the testimony of our next panel. I want to welcome each of you to the committee. As I mentioned to the previous panels, the rules of the committee are that we would like for you to limit your oral testimony to the committee to 5 minutes or less. The red light will come on at the time 5 minutes is up. You will be permitted to submit your entire written statement into the record without objection.

Our first witness this morning is James Morgan, president-elect of the National Venture Capital Association. We are pleased to have you and you may proceed.

STATEMENT OF JAMES F. MORGAN, PRESIDENT-ELECT, NATIONAL VENTURE CAPITAL ASSOCIATION, AND PRESIDENT, MORGAN, HOLLAND VENTURES, INC., BOSTON, MASS.

Mr. MORGAN. Thank you, Mr. Chairman. It is a great pleasure to be with you this morning, although I have to confess that is a tough panel to follow. You have had some very interesting testimony. I have been reflecting, it is 28 years almost to the day that my favorite professor asked me to join him in the venture capital with a company called American Research and Development, and when Fortune magazine did a cover story on what General Derorio did, they called it a dream factory. And much of what you have been dealing with this morning, much of the testimony you have heard, has that dreamlike aspect to it. Venture capitalist entrepreneurs teaming together to build great corporations are really nothing more than the fulfilling of the American dream, the dream that Americans have to create wealth for their families, for risk takers, so that the family can take its role as the major social body in this country, take care of its elderly, educate its children.

I might also point out that a great deal of wealth that is created in this process goes into philanthropy. And as we have all been watching the unfolding events in Washington the last few months, we recognize that the role of private philanthropy is going to become more and more important as the government just can't take care of these social programs where I am from in Boston, the major universities, hospitals, inner-city education programs, inner-city parochial schools, museums, the arts.

These are very, very heavily supported by the successful entrepreneurial activities that take place in the high-tech regions in Boston. The entrepreneurs don't seek subsidies or handouts from the government, really just a chance to build these dreams into realities and to build net worth to build wealth.

In the materials that have been distributed, you will have a great deal of information, statistical information regarding the role of patient capital. We have distributed to you the Fifth Annual Venture Capital Economic Impact Study which documents the jobs creation, the tax base growth, exports. Basically it tells the story of the gazelles of the American economic scene, the companies that move quickly. They spot and seize opportunities and as a result create the jobs, the tax base, exports, quality of life.

It also documents that in recent years, and I see no reason why this trend shouldn't continue, maybe even accelerate, there is an increasing level of capital needed to launch the truly major corporations that are going to be the international competitive companies of tomorrow. It just simply takes more money.

You have got to get to market faster. You have got to build a local company faster. Product life cycles are shortened so the slow growth scenario that was very much a part of building a venture-backed company when I joined the industry 28 years ago just doesn't work today. If you follow a flow growth path, chances are that somebody will knock you off before you have a chance to build an interesting company.

There has been a decline in sources in a relative manner of capital for building companies. We look at the buildup of capital in this country, take for example the equity mutual funds. They have grown at a staggering rate so that now they are four times as large as they were 10 years ago or so, whereas venture capital has remained relatively constant in absolute dollars, a fairly small pool of capital but with the mutual funds and other sectors of capital markets growing very rapidly.

So the suggestion that venture capital is alive, well, and healthy is not statistically accurate because the percentage of capital being allocated by our capital markets has fully been declining. There are a smaller number of companies that have been supported and corporations are far less active.

Very importantly, and not too widely mentioned so far today, is the role of the individual, angel investor as we call them. Very many of the companies that we start get their initial launching from angel investors. The written testimony of the National Venture Capital Association, as I mentioned, provided statistics. You will hear from some more entrepreneurs later on in the panel.

I would like to make one comment about the motivation of founders. There was some suggestion that founders don't examine the possible payoff from the fruits of their hard work. I have been involved with entrepreneurs all my life and I would reject that point. First of all, I think, by the way, today's generation of company founders are far more sophisticated.

Those spreadsheets and analytical techniques are available now that really weren't available 20 or 30 years ago. Sure, an entrepreneur will not be deterred, but it is just not fair if he realizes at the end of the day that a great portion of his winnings for which he risked so much are going to be taxed away. There is a breaking of a social contract there and it also takes place with employees who benefit from stock options.

Those stock options as options are not useful. The stock doesn't buy a house. They eventually have to sell that holding and it is on the sale that it finally dawns on them that the tax man is there taking a great deal of the bite out of their profit, this profit that they risked and worked hard for, and I think that is a little bit behind some of the concerns that you see in the country now about what is happening in Washington.

I think that the vitality of the growth sector has never been more critical, and what we as a National Venture Capital Association are recommending is sweeping tax changes to relocate the allocation of capital back to those who are closest to the opportunities and problems of society. I think that is really at the core of the opportunities of society which, as I understand it, both parties are attempting to build. And I appreciate the chance to comment.

[The prepared statement and attachment follow:]

TESTIMONY OF JAMES F. MORGAN
NATIONAL VENTURE CAPITAL ASSOCIATION

The National Venture Capital Association (NVCA) is an association of nearly 200 professional venture capital organizations located throughout the United States. It was organized in 1973 to foster a broader understanding of the importance of venture capital to the vitality of the U.S. economy. Its affiliate, the American Entrepreneurs for Economic Growth,is composed of nearly 8,000 emerging growth companies which employ over one million Americans.

Mr. Chairman, the NVCA appreciates the opportunity to present its views on the U.S. economy and proposals " to encourage Americans to increase savings and investment". In light of the current adverse investment climate for growing businesses, particularly for high technology companies, we are convinced that enactment of a significant reduction in the tax on capital gains could go further to promote economic opportunity and growth, international competitiveness, as well as increase savings and investment, than any other single legislative change.

As active participants in the entrepreneurial process for over 25 years, NVCA hopes to shed light on what is happening to our country's emerging companies as they struggle to develop new technologies and products that enhance our ability to compete in the world marketplace.

Our interest in this matter is intense because the venture capital industry has been at the forefront of creating and growing some of the most successful businesses in America today: Apple Computer, Genentech, Sun Microsystems, Federal Express, Intel, Silicon Graphics, America OnLine, and Thermo Electron are just a few of our past successes. Venture capitalists continue to fund new technologies in critical fields such as medical device, communications, environmental, biopharmeceutical, and software. In fact, in 1994 INC. magazine's list of its fastest growing public companies contained 56 venture-backed companies...this at a time when venture capital funding still has not reached the heights it did in the 1980's.

These important successes sometimes overwhelm the critical importance of many of our growing companies to the welfare of this society. Companies in which venture capitalists now are helping to grow include those that will give hope to people across virtually the entire spectrum of diseases and afflictions. Other companies are attempting to control hospital costs through medical innovations as well as through new software and communications applications. This private sector response to issues the government and the American public want solved can only move forward if investors are given sufficient motivation to provide funding to these businesses for a long period of time.

PATIENT LONG-TERM EQUITY CAPITAL, i.e. VENTURE CAPITAL IS ESSENTIAL FOR RAPIDLY GROWING COMPANIES

Patient, long-term equity capital is the lifeblood of America's entrepreneurs and their young growth companies. In such diverse areas as biotechnology, computer sciences and environmental sciences, these rapidly growing companies are creating new industries, developing new technologies and producing new products. They are the engines which drive America's economic growth, and represent in the starkest manner American workers' ticket to economic opportunity. However, they also have voracious appetites for patient, long-term equity capital - i.e. venture capital.

The National Venture Capital Association recently conducted its fifth study on the economic impact of venture capital on the U.S economy. This research demonstrates strongly that young, venture-backed companies generate a significant stream of benefits for America's economy which will be expanded upon infra. However, this research also shows that the jobs, technical advancements, exports, and asset growth created by venture-backed companies comes with a mounting price tag. U.S. venture-backed companies founded between 1981 and 1985 needed an average $7 million in venture capital during those first five years to sustain themselves and grow. This venture capital financing hurdle jumped to $10 million for growing companies founded between 1985 and 1989. Today, America's star emerging companies, founded between 1989 and 1993, need an average of $12 million in venture capital by the time they are 5 years old to survive and thrive.

PROFESSIONAL VENTURE CAPITAL AND INFORMAL INVESTORS ARE THE ONLY DOMESTIC SOURCE OF EARLY STAGE, PATIENT LONG-TERM CAPITAL FOR AMERICA'S EMERGING GROWTH COMPANIES

Traditional sources of debt capital are not available to these companies because they lack the track record or collateral to back up a loan. Young growth companies absolutely require equity and their only significant sources for equity capital are individual and corporate venture capital investors and professional venture capitalists.

Unfortunately, there has been a decline in institutional venture capital financing. The peak year for fund raising by the industry was $4.2 billion in 1987; in 1991 only $1.3 billion was raised for pure venture capital financing. 1992 and 1993 saw increased activity of $2.5 billion. 1994 figures, now being compiled, initially show activity for the year in the low $3 billion range which is encouraging, but still falls well below the figures of the mid 1980s.

By comparison, while the venture capital industry has been treading water, money continues to flow into the mutual fund industry. In 1987 while institutional venture investors raised $4.2 billion, equity, bond and income funds had net sales of $74 billion. In 1993 the numbers were $2.5 billion and $280 billion respectively.

Venture capital's situation also can be seen in the number of small emerging companies that were financed with professional venture capital since the ramifications of the 1986 and 1993 acts were felt. The peak in the number of companies attracting investment again occurred in 1987 when professional venture investors funded 1,737 new and growing companies. That number has declined virtually every year since, so that in 1993 just under 1,000 such businesses were funded. Think of the jobs that could have been created had not this decline taken place.

Finally, corporations, one of the taxpaying entities which fund venture capitalists, have decreased their investment in institutional venture capital. New money invested in institutional funds by corporations dropped to $200 million in 1993, (excluding direct investments by corporations in emerging growth businesses).

In addition to the decline of institutional investing, there has been a withdrawal of the individual or "informal" investor from the long-term, high risk marketplace who, as a result of the 1986 and 1993 tax changes, has moved to a shorter-term, more risk-averse profile. These "informal" investors are the mothers and fathers, the aunts and uncles, and the doctors and office workers, as well as already successful businessmen who typically provide over 90 percent of start-up capital in small companies.

This is of profound importance. Professional venture capital firms, such as those represented by the NVCA, provide a critical, albeit small, portion of the total capital invested in young companies each year. The fact is that the vast majority of the new and growing firms in this country are not appropriate investments for professional venture capitalists, or they need less capital than professional venture capitalists typically invest. The entrepreneurs who found most companies must seek their capital directly and informally from individual investors.

A 1988 Small Business Administration study found that informal investment "appears to be the largest source of external equity capital for small businesses. Nine out of ten investments are devoted to small, mostly start-up stage firms with fewer than 20 employees."

These figures are important because opponents of a lower capital gains tax often contend that untaxed institutions, predominately pension funds, play a major role in supplying venture capital firms with the capital to invest in emerging companies. However, as demonstrated it is the informal investor who puts a major [redacted] share of dollars into our country's vital small growth companies and nearly all of these informal investments come from taxpaying investors.

This point was made just last month when INC. magazine showcased America's 500 fastest growing private companies. These companies, which now employ over 47,000 and average 6 years in age, received all or a portion of their start-up capital from the following sources:

personal savings (71%); other family members (27%); friends (12%); other informal venture investors (13%); formal venture investors (13%) and other employees or a partner (19%).

In sum, we need the individual investor because they often are the investors in seed and start-up companies which as they begin to germinate become attractive to institutional investors who generally invest larger sums. Individual investors also provide liquidity in public securities markets, buying equities in growth oriented, small cap companies on their own and through company stock purchase plans and stock option plans, discussed infra. Institutional venture capitalists and individual investors are thus dependent upon one another and this relationship is very sensitive to the vagaries of the tax law.

RECENT TAX POLICY HAS NOT ENCOURAGED YOUNG GROWTH COMPANIES TO REACH THEIR POTENTIAL

To be sure, small and emerging businesses always will have problems raising capital as investing in them entails a high degree of risk. However, government can make the problem less onerous and in the process help the Nation.

Unfortunately, recent tax policy has made capital more expensive for young and emerging growth companies. In short, tax changes enacted in 1986 and 1993 hurt America's small business community because they rewarded short-term profits over stable, long-term investment. This in turn has led to a higher cost of patient, long-term capital and an erosion in America's technological and innovative leadership, thus reducing our ability to compete internationally.

The increase in the cost of capital is especially burdensome to young growth companies because: 1) they rely heavily on equity finance rather than debt, 2) they need patient rather than short-term capital, and 3) they typically reward their investors with long-term capital gains, while mature companies reward their investors with dividends or interest.

While the Omnibus Budget Reconciliation Act of 1993 and the 1986 Tax Reform Act included some provisions which stimulated the U.S. economy, they unfortunately had a negative affect on small and young emerging high-growth companies because they penalized long-term investors. Recent attempts at "tax reform" have penalized these visionary investors by raising the long-term capital gains rate while simultaneously providing a boon for short-term investors. Our tax policy, in effect, is channeling funds away from long-term investments which are crucial to our economic vitality. In taxing capital gains as ordinary income, Congress in 1986 sent a clear signal to individuals and corporations that there was nothing special about long-term investments. As a result, patient investment in productive job-creating enterprises has been sacrificed for short-term gains.

This situation was not helped by the perverse legislative development which occurred in 1993. When Congress voted for the Clinton budget package it in affect created something we believe is worthwhile: a tax rate differential between capital gains and ordinary income. However, this differential was created by raising ordinary tax rates, not lowering capital gains rates. If we want Americans to save and invest we have to allow them to keep some money to do just that. This won't occur by raising ordinary tax rates thereby creating an artificial differential which many Americans do not have the resources to take advantage of.

In addition, while the "targeted capital gains" provision in the budget package was well intentioned and supported by NVCA, we viewed it then and now as a first step in the process to produce a meaningful, broad-based capital gains reduction.

In short, the decline in professional venture financing, in combination with the rapid withdrawal of the individual and corporate investor from the small company marketplace, has created an environment where small companies have virtually lost one of their principal avenues for raising new capital. This lack of private venture capital in the U.S. is forcing some of America's capital intensive young growth companies to look for capital overseas.

Based on these circumstances, any change made in tax policy must stimulate investment in young, growing businesses if you wish to spur the economy, create new jobs, produce goods for export and increase consumer confidence. The best way to stimulate the needed investment is to create a meaningful differential in the tax system between ordinary and capital gains rates which will make it attractive to individuals and corporations to once again give up liquidity and security in exchange for long-term appreciation.

PUBLIC POLICY WHICH ENCOURAGES LONG-TERM INVESTMENT IN GROWTH COMPANIES WILL BENEFIT THE ENTIRE NATION

The National Venture Capital Association recently conducted its fifth study on the economic impact of venture capital on the U.S. economy. The results demonstrate the importance of venture-backed companies which typically are technology-oriented. Despite their youth, the 500 companies in the survey grow jobs incredibly quickly: in year one of existence they averaged 16 employees while those who are now six years old average 218 employees. The average annual job growth rate of these survey companies is an astounding 25% versus a net loss of 3% in Fortune 500 companies between 1989-1993. In sum, venture-backed companies aggressively grow jobs for America's workforce.

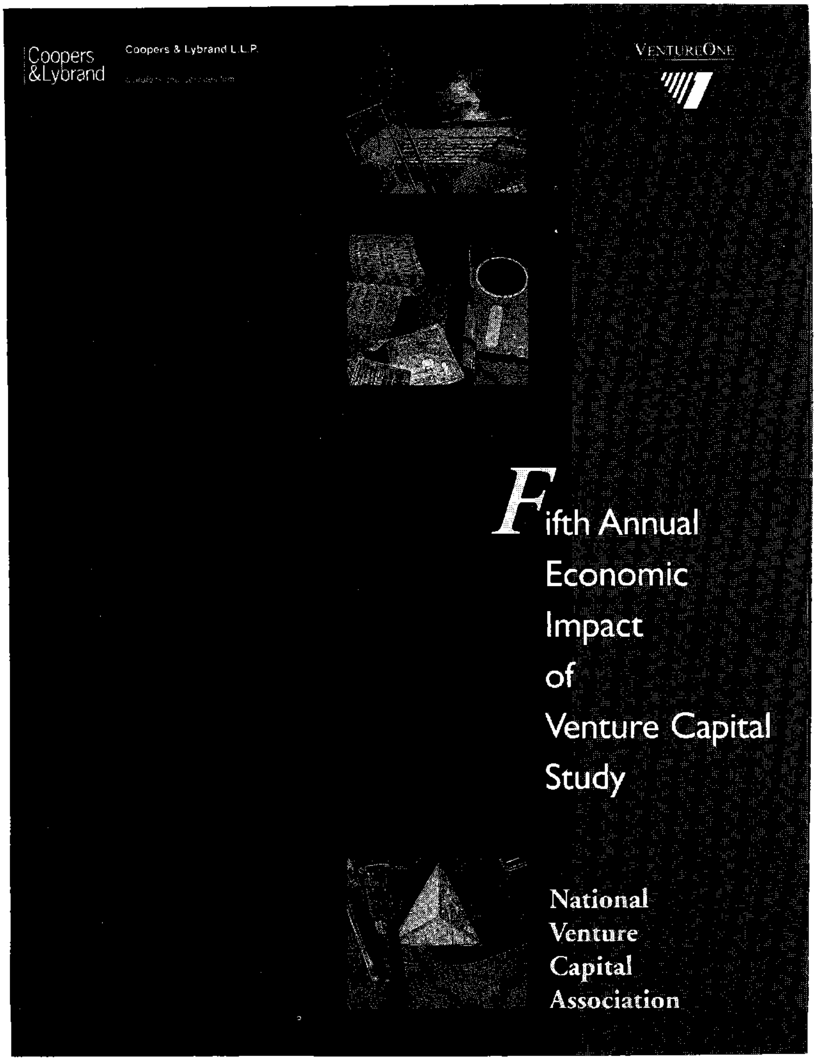
Despite these impressive statistics, employees of emerging growth companies take a major gamble working in this sector of the economy and should be rewarded for doing so. Today millions of working men and women in rapidly growing enterprises receive stock options and participate in stock purchase plans. Venture capitalists have learned that employees who are treated fairly and have an actual stake in the operation and potential profitability of a company can produce incredible results. When these results occur, and they by no means certain, we believe that employees should not be penalized by being taxed at the identical rate of ordinary income and at a rate not indexed for inflation. It simply is not fair and runs counter to America's entrepreneurial spirit.

NVCA's latest research also indicates that venture-backed companies create a greater percentage of skilled jobs, and do so more cost effectively. For example, engineers, scientists and managers composed 59% of all the jobs produced by our survey companies, while they compose less than 15% of the United States labor force.

Our research also found that venture-backed companies invest more in plant, property and equipment as well as research and development than Fortune 500 companies. While Fortune 500 companies spent on average 7% of their equity on research and development between 1989-93, venture-backed survey companies spent 23% or more than three times as much. A copy of the NVCA survey is attached for your review.

Providing entrepreneurial companies with long-term, low-cost capital through a capital gains reduction also will sow the seeds for future growth. NVCA's research found that benefits to the economy from venture-backed companies multiply quickly. The term "international start-up" powerfully describes the competitive nature of these young companies. Already, these companies averaging only 4.5 years in age have generated $4 million each in export sales from 1989 to 1993. Between the time the average survey company was one year old, it grew export sales an average of 171 percent each year.

This research, conducted by Coopers & Lybrand and the research firm VentureOne, demonstrates strongly that young, venture-backed companies generate a significant stream of benefits for America's economy. However, the jobs, technical advancements, exports, and asset growth created by venture-backed companies need to be nurtured. America needs a more hospitable environment for investment, particularly early-stage investment in small emerging growth companies. We need to bring the individual and corporate investor back into this market. In doing so America's entrepreneurs will become convinced that long-term capital will be available to begin and expand their operations. NVCA believes strongly that an immediate reduction in the existing capital gains rate will produce this message and move our Nation's economy foreword.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VENTUREONE
Fifth Annual
Economic
Impact
of
Venture Capital
Study
National
Venture
Capital
Association

About the Survey

The foundation of America's economic strength has been driven by entrepreneurs with vision and drive. These visionaries use their technical and managerial skills, supported by critical financing, to build new industries, create new companies and jobs, add wealth to America's workforce, and keep the United States strong and competitive.

This report, the ***Fifth Annual Economic Impact of Venture Capital Study***, focuses on the venture capital link between an entrepreneur's vision and the resulting effect on America's economy.

Over 1,800 questionnaires were sent to young, venture capital-backed companies. They were asked about their financial activities over the past five years. We received 495 responses (almost 28 percent) from these emerging businesses.

Because the financial data provided by these survey companies is generally not publicly available, this report delivers valuable insight on the impact young venture-backed companies have on our economy. The data was analyzed using means, or averages. In many cases, the results are compared to the economic impact of the Industrial Fortune 500 companies. This comparison helps benchmark the effect these young companies have on job creation, research and development, long-term capital investment and other critical areas of our economy.

A project of this caliber is only possible with a dedicated and qualified team of players:

- The National Venture Capital Association (NVCA) sponsored the study, providing overall guidance and support.
- VentureOne undertook the task of surveying the 1,800 venture-backed companies and building the database of responses.
- Coopers & Lybrand L.L.P., using VentureOne's database, analyzed the numbers and developed this report.

For a description of the NVCA, Coopers & Lybrand L.L.P., and VentureOne Corporation, or to find out how to order more copies of this report, please turn to page 12. An explanation and definition of venture capital can be found on page 11.

Executive Summary

The economic impact of venture capital-backed companies is measured annually by Coopers & Lybrand L.L.P. and VentureOne Corporation for the National Venture Capital Association. Almost [illegible] companies [illegible] to the [illegible] annual [illegible]. The findings [illegible] are [illegible] *Chart 1.*

Venture-Backed Companies Are Engines of Quality Job Creation

The [illegible] companies [illegible] hand from 198[illegible] generate an average of [illegible] U.S. jobs per company. For the first five years of a venture-backed company's life, it grows its workforce nearly [illegible] percent annually.

Professional Venture Capital Helps Companies Create Breakthrough Technologies and Products, Enhancing U.S. Competitiveness

[illegible] companies [illegible] of capital in research and development [illegible] an average of $8.[illegible] million per company between 1989 and 1993. By the time the typical [illegible] company is five years old, [illegible] its investment in research and development [illegible] percent [illegible].

Rapidly Growing Venture-Backed Companies Boost U.S. Competitiveness

Today's venture-backed companies aggressively grow export sales. From 1989 to 1993, the average young survey company generated $4 million in exports. During the [illegible] five years of these companies' [illegible] export sales [illegible].

Venture Capital Cash Requirements Intensify Over Time

Today's entrepreneur faces greater financing challenges than yesteryear's visionaries to generate this significant economic benefit stream. The average amount of venture capital required by start-up companies during their first five years of life has risen considerably since the early 1980s. Companies founded between 1981 and 1985 needed an average of $7 million [illegible] venture capital during [illegible].

Companies that were founded and raised venture capital between 1985 and 19[illegible] saw this financing threshold rise to $10 million. Most recently, young venture-backed companies founded between 1989 and 1993 [illegible] raise an average of $[illegible] million during these [illegible] thrive. [illegible]

[illegible] percent [illegible] equity from professional venture capitalists who [illegible] the company's [illegible] *Chart XVIII on page [illegible].*

As more companies secure venture capital financing, the positive impact on our economy continues [illegible].

Chart 1
Venture-Backed Companies Stimulate Our Economy

	Economic Benefits Generated Between 1989 and 1993	Growth Rates During a Company's First Five Years
Job Creation	[illegible] jobs per company	[illegible] annually
Investment in Research & Development	$8.[illegible] million per company	[illegible] annually
Export Sales	[illegible]	[illegible] annually

Coopers & Lybrand L.L.P.

Participant Profile

For the truest image of the impact that venture capital investments have on our economy, this study only looks at young, emerging companies that have few other financing alternatives. Almost half of the study's participants are less than four years old *(Chart II)*.

Nearly 80 percent of these new companies are private *(Chart III)*. They depend on private equity to help fund research and development, pay workers, invest in capital equipment, and expand their markets.

Their most significant source of equity is professional venture capital. Venture capitalists contribute more than critical financing. These seasoned investors lend experience and business savvy to the company, guiding the young venture along.

Chart II
These Companies Are Young
Survey Companies' Age

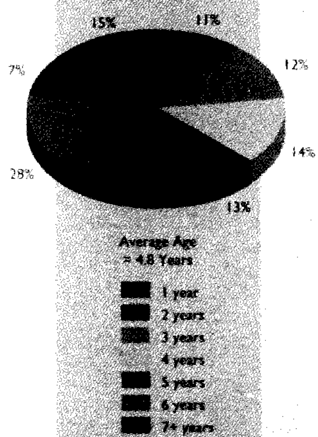


Chart III
They Are Mostly Private ...for Now
Survey Companies' Ownership Status

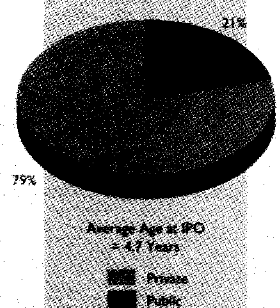
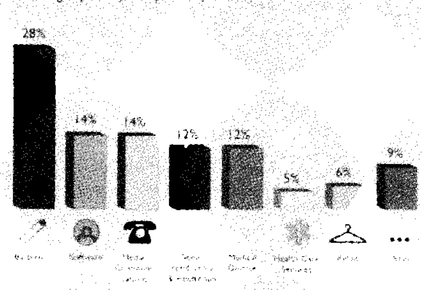


Chart IV

They Focus on Growth Industries

Percentage of Survey Companies by Industry



Coopers & Lybrand L.L.P.

Venture-Backed Companies Are Engines of Job Creation

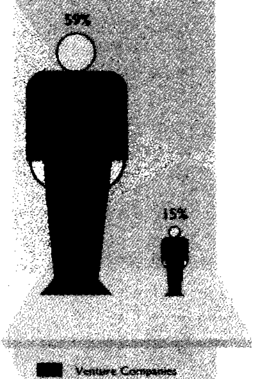
Job growth is at the heart of economic strength. With the support of venture capital to develop technologies and products and expand operations, these young survey companies work hard to provide jobs for America's workforce. On average, the venture-backed companies in our analysis generated 152 U.S. jobs per company from 1989 to 1993.

America's economic strength is also grounded by the strong foundation of a technically skilled workforce — the kind fostered by venture-backed companies.

The percentage of highly skilled engineers, scientists, and managers generated by young survey companies is almost four times greater than the percentage of skilled jobs created in the economy as a whole *(Chart V)*. As these venture-backed survey companies expand operations, the percentage of production and other positions should also increase.

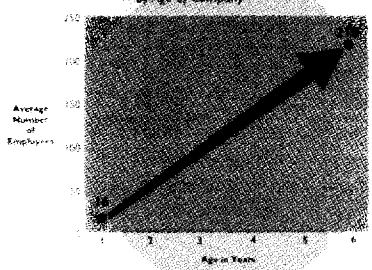
As venture-backed companies mature, their workforce grows dramatically. In the first five years of a survey company's life, the average number of jobs grew nearly 90 percent annually. They typically begin with a small, dedicated workforce concentrating on research and development. As they grow, operations expand and they add to their manufacturing, sales, marketing and other staffs. By the time the average survey company is six years old, it employs over 200 people *(Chart VI)*.

Chart V
Venture-Backed Companies Create a Greater Percentage of Skilled Jobs
Percentage of Engineers, Scientists and Managers in Labor Force



Source: U.S. Bureau of Labor Statistics, 1994

Chart VI
Survey Companies Grow Jobs Quickly
Average Number of Employees by Age of Company



Venture-Backed Companies Create Breakthrough Technologies and Products

[illegible]

Chart VII

Venture-Backed Companies Aggressively Grow Jobs for America's Workforce

Average Annual Job Growth Rate 1989 - 1993

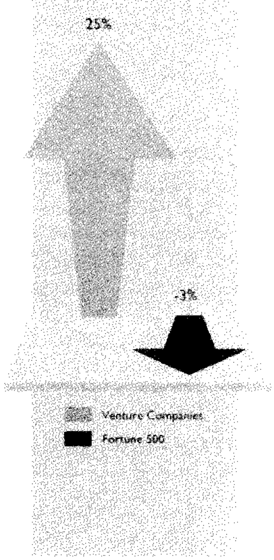
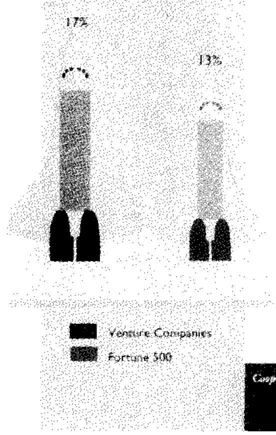


Chart VIII

Investment Equity Fuels the R&D Engine

Average R&D/Equity 1989 - 1993



The average survey company also invested twice as much in R&D per employee as the Fortune 500 companies *(Chart IX)*. Over the past five years, venture-backed survey companies increased their annual investment in R&D four times faster than Fortune 500 companies *(Chart X)*.

These emerging companies, through their obvious commitment to research and product development, will expand America's technical prowess into the next century. As more venture capital is invested in these promising companies, greater product and service development breakthroughs can be realized.

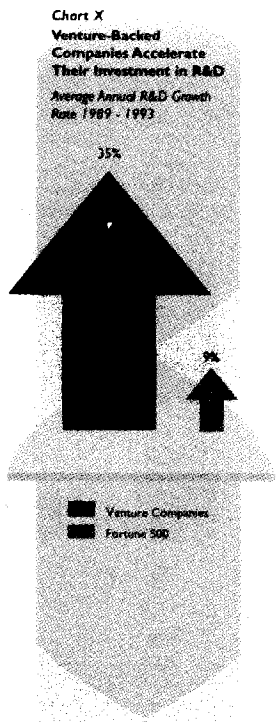
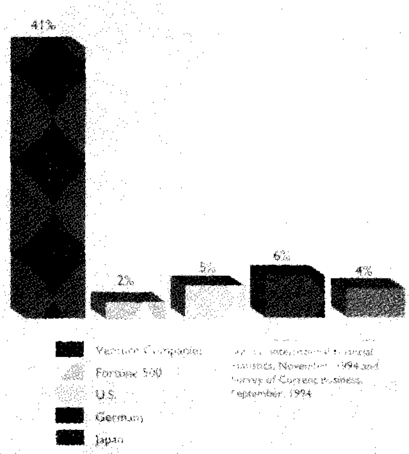


Chart XI

Venture-Backed Companies Boost U.S. Competitiveness

Compound Average Sales or GDP Growth Rate 1989 - 1993



Coopers & Lybrand L.L.P

Already, these companies, again averaging only 4.8 years in age, have generated $4 million each in export sales from 1989 to 1993. Between the time the average survey company was one year old until it was five years old, export sales more than tripled each year. As a percentage of revenue, export sales have become an increasingly important component for venture-backed companies over the past five years, helping to improve America's balance of payments.

In 1989, exports comprised only four percent of total revenues of the average survey company. By 1993, sales from global markets made up 11 percent of total revenues for these aggressively growing companies *(Chart XII)*.

Venture-backed companies also soar in productivity, sharpening America's competitive edge. From 1989 to 1993, the average survey company grew sales per employee 12.4 percent each year, more than twice the productivity growth rate for Fortune 500 companies during the same time period *(Chart XIII)*.

Chart XII

Venture-Backed Companies Work Hard to Improve our Balance of Payments

Average Exports as a Percentage of Revenue 1989 - 1993

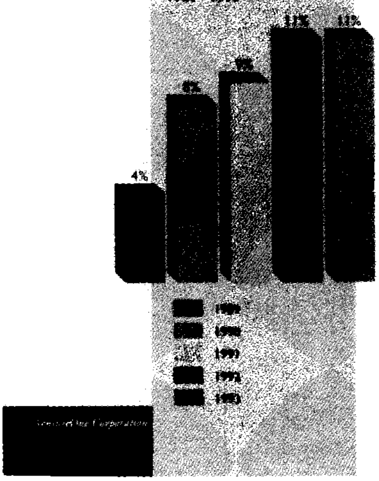
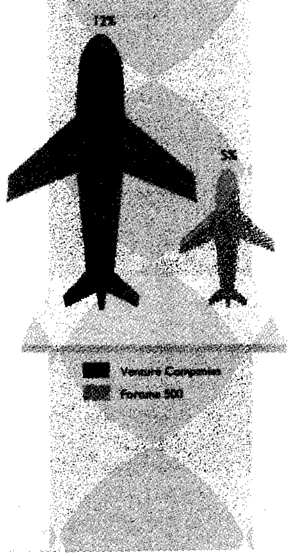


Chart XIII

Venture-Backed Companies Soar in Productivity

Average Annual Sales per Employee Growth Rate 1989 - 1993



[illegible]

Survey Companies Invest in the Future

Venture-backed companies [illegible] 1993, [illegible] 23 percent of their [illegible] revenue on long-term capital investments. At the same time, Fortune 500 companies spent only 7 percent of their revenue investing for the future (Chart XIV).

Venture-Backed Companies Spend Their Hard-Won Equity on Critical Resources

The average venture-backed start-up company does not generate significant revenues during [illegible] investments to finance [illegible] inventory, and other critical resources necessary to grow. From 1989 to 1993, the average survey company used 90 percent of the equity it raised to finance these vital assets. In contrast, Fortune 500 companies needed only one-third as much equity to sustain a proportional level of assets (Chart XV).

[illegible] companies [illegible] the equity [illegible] five [illegible] annually. Fortune 500 companies, which can [illegible] earnings and debt to [illegible] growth, need less and less equity each year to support the same level of assets. (See Chart XVI on page [illegible].)

Chart XIV

Venture-Backed Companies Invest in Capital Equipment at Three Times the Rate as Fortune 500 Companies

Average PPE/Revenues 1989 - 1993

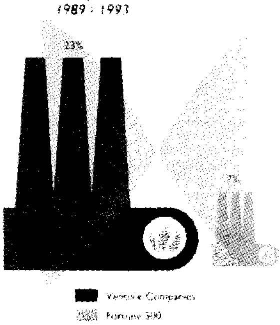


Chart XV

Venture-Backed Companies Finance Critical Resources with Hard-Won Equity

Average Equity/Assets 1989 - 1993

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Cash Requirements Intensify Over Time

The economic benefits stream created by venture-backed companies comes at an increasing cost. U.S. venture-backed companies founded between 1981 and 1985 needed an average of $7 million in venture capital during their first five years to sustain themselves and grow. This venture capital financing hurdle jumped to $10 million for growing companies founded between 1985 and 1989. Today, America's emerging companies founded between 1989 and 1993, need an average of $12 million in venture capital by the time they are five years old to survive and thrive (Chart XVII).

Venture-backed companies have few other financing vehicles to underwrite their growth. Professional venture capitalists provide, on average, 69 percent of each survey company's total equity (See Chart XVIII on page 11). Venture capital financiers invest alongside the companies' founders while contributing their experience and industry knowledge to help companies avoid start-up pitfalls and move them toward becoming tomorrow's leading industrial and service companies.

As more young companies find the venture capital they need to create jobs, generate exports, build advanced products and services, and invest in capital equipment they will continue to forge a positive impact on a strengthened U.S. economy.

Chart XVI

Venture-Backed Companies Need an Increasing Amount of Equity to Support Resource Growth

Average Annual Equity/Asset Growth Rate 1989 - 1993

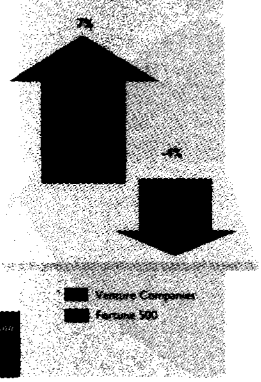
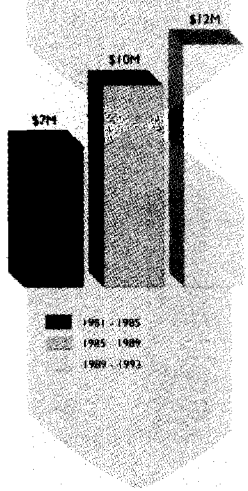


Chart XVII

The Magnitude of Start-Up Financing Required by Survey Participants Grows

Average Venture Capital Invested per Company

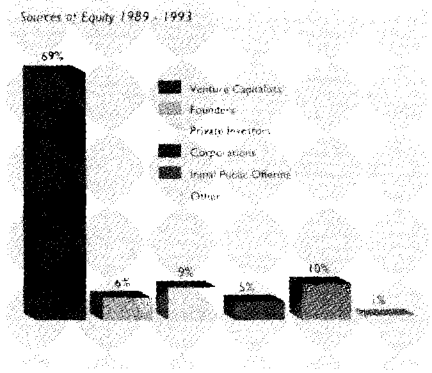


What Is Venture Capital?

Chart XVIII

These Companies Depend on Venture Capital

Sources of Equity 1989 - 1993



Coopers & Lybrand L.L.P.

About the Participating Organizations

The National Venture Capital Association (NVCA)

The NVCA is an association of 200 professional venture capital organizations with over $40 billion of capital under management. [illegible] firms organized the association in 1973 to foster a [illegible] of the importance of venture capital to [illegible] of the U.S. economy.

The American Entrepreneurs for Economic Growth (AEEG)

The NVCA also represents over [illegible] emerging growth companies through the American Entrepreneurs for Economic Growth. The AEEG is the nation's largest entrepreneurial network, representing over one million jobs in the United States.

Coopers & Lybrand L.L.P.

Coopers & Lybrand L.L.P. is one of the world's leading international professional services firms to entrepreneurs and venture capitalists. Coopers & Lybrand's National High Tech and Venture Capital Groups provide accounting, auditing, tax and consulting services to emerging and mature technology companies.

VentureOne Corporation

VentureOne is a leading provider of investment research to venture capital professionals. VentureOne's clients license the VentureOne Data System, a comprehensive database tracking the [illegible] and financing [illegible] venture-financed companies in the [illegible] $15 billion [illegible] capitalists, [illegible] and business development professionals.

For details on the survey or any of these organizations, contact:

National Venture Capital Association:
703-351-5269

American Entrepreneurs of Economic Growth:
[illegible]

Coopers & Lybrand L.L.P.
[illegible]

VentureOne Corporation:
415-357-2100

To order additional complimentary copies of this survey, please call either the NVCA or Coopers & Lybrand L.L.P.

Chairman ARCHER. Thank you, Mr. Morgan.

Our next witness is Christopher Brody who is the chairman of the tax committee of the National Venture Capital Association.

STATEMENT OF CHRISTOPHER W. BRODY, CHAIRMAN, COMMITTEE ON TAXES AND INCENTIVES, NATIONAL VENTURE CAPITAL ASSOCIATION; AND PARTNER, WARBURG, PINCUS & CO., NEW YORK, N.Y.

Mr. BRODY. Thank you, Mr. Chairman and members of the committee. I am also partner——

Chairman ARCHER. Mr. Brody, if you will indulge me suspending for a moment. I would like to recognize my colleague, Charlie Rangel, to make an introduction and I apologize for overlooking him.

Mr. RANGEL. Both Amo Houghton and I thank you, Mr. Chairman, for an opportunity to acknowledge the contribution that Mr. Brody and his National Venture Capital Association has made in creating jobs and how necessary it is that we continue to reward those who take the risk.

We also are concerned with a piece of legislation that both Mr. Houghton and other members of this panel are supporting that would remove some of the impediments of the capital gains incentives we have provided as relates to the tax treatment of section 212 and partnership investment expenses, and Mr. Houghton joins me in welcoming you to this panel.

Mr. BRODY. Thank you very much. We are very appreciative of all of your support.

Chairman ARCHER. Mr. Brody, you may proceed.

Mr. BRODY. Thank you.

I am a partner of Warburg, Pincus & Co. and I have been a full-time venture capitalist for more than 25 years, during which time our firm has provided long-term equity capital to over 200 businesses.

We are often asked, "What is venture capital?" I believe it is the process of providing both long-term, patient, risk equity capital with substantial human resources of the venture capitalist working on an ongoing basis with portfolio companies to help them achieve their goals.

Venture capital includes the following three characteristics. One, we provide equity capital as long-term investors in partnership with management. Second, we are actively involved not only in assembling and organizing the capital in partnership form and in making investments in portfolio companies, but we work extremely close with these companies on an ongoing basis sometimes serving as chairman of the board or chairman of the management company of these companies. Our commitment is very time-intensive.

Third, we are not investment bankers, we do not take transaction fees, and we are only successful economically if our portfolio companies are successful.

What I would like to do this morning is to describe a specific investment. It happens to be one which was very successful because most investments do not work out this well either for the investors or for the management employees, when they do, the opportunity to be able to retain on an aftertax basis the benefit of such success is extremely important and the willingness to take some risks is significantly enhanced by the capital gains rates structure in this country.

In mid-1989, our firm was approached by a husband and wife entrepreneur team who had written a software code which enabled the users of the product to prepare their own tax returns on PCs. The husband had originally written the product to help himself. His friends said it was better than anything else on the market. His wife quit her job as a schoolteacher, literally moved the car out of the garage and used the garage as a shipping bay as they started this company. The name of company is ChipSoft and the product, TurboTax, is the leading product today in the preparation of tax returns on PCs.

When we met these people, ChipSoft was essentially a tax software product. It was not a company. It had outgrown the capability of its founders who were stressed out and wished to retire, had no business plan or strategies, no business infrastructure, and operational problems which were so severe that on my second visit to the company the computer which kept track of all operations and shipping crashed three times in one morning.

The commitment that we made to the founders was that we would buy a majority stake in the company. The founders retained 18 percent and another eventually nearly 20 percent was set aside for management and all employees. We committed to share responsibility for management of the company unless a professional CEO had been recruited.

We realized that in the long run, the culture of the company had to be changed. The people inside the company were already stretched and they would have to be motivated to work incredible hours for which cash compensation was not adequate. That was the reason why we decided that every employee in the company—there were 60 full time at the time, today there are 1,200 as I will explain—receives stock options. Those options, together with additional shares which were subsequently issued to attract and recruit additional people to the company, have a value today of $80 million.

During the 6-month period, before we made our investment, three of us from our firm—one of my other partners, myself and an associate—conducted a market research survey of the industry, drafted a strategic plan for the company, designed a new organization chart, laid out a recruiting plan, and negotiated the structure of the investment.

You may think that this was a lot of work but the pressure really started the day after we invested because it was not only their company, it was also ours. We set out immediately to recruit a top CEO. That took 6 months before we found the right person. In the meantime—and we worked with him to recruit six individuals to the tax management of the company, most of whom came from higher paying safer jobs in large corporations, recruited a world class board of directors, helped the company make acquisitions with its common shares to acquire other products which it was going to need to grow, and ultimately helped the company negotiate with underwriters for an IPO.

By mid-1993, it was clear that the marketplace was consolidating and that the functions that we performed would be integrated with other functions. We had had a comarketing agreement for years with a compatible product which was a personal finance product managing a checkbook with a PC. And in the end of 1993, that company, which was called Intuit, whose product is Quicken, is the leading product in its marketplace, was merged with ChipSoft and we had a company doing over $200 million in sales with substantial growth potential.

Today the combined companies, both of which were total startups in the eighties, are operating a $350 million annual sales rate employing 1,200 full-time employees in operations located on the west coast, Midwest, Southwest, and Southern parts of the United States, serve 4 million home users as well as thousands of small businesses and are now starting to generate significant revenues from international exports.

They are also becoming a significant Federal, State, and local taxpayer. We believe the company has also dramatically enhanced the productivity of its customers.

This has obviously been a very successful experience for the founders, entrepreneurs, the professional management who left more secure positions in exchange for an opportunity to grow a business and get a capital gains, employees who had stock options, a board of directors who did not receive a penny in cash but got stock in return for a significant commitment to help the company. And of course it has been very successful for the investors.

The original informal backers, the angels who loaned these people some money their first day, the venture capitalists and our limited partners and the shareholders who acquired their interest in the IPO and subsequent trading market, without all of whom this, could not have happened as it did. What we all have in common in varying degrees is that we all took risks because we were motivated by the potential for capital gains, and because we were successful we were rewarded.

One final caveat I would like to leave in closing, a 50 percent or some other dramatic reduction in capital gains rates would have a very salutary effect on the venture capital entrepreneurial process. In the past, there has been a suggestion and at one point in the tax law this has been coupled with making this a preference item if it was an exclusion for AMT purposes. Our calculations indicate that would result in no change.

I would urge the committee in their deliberations on capital gains, that they look at capital gains net, that is, after all AMT applications, both preference items for exclusions and, as Congressman Rangel referred to, the inability of venture capital firms today to deduct their expenses against the capital gains that they generate if they are successful.

I want to thank you very much for giving our industry an opportunity to testify at the hearings today and obviously would be very happy to answer any questions that you wish.

[The prepared statement and attachment follow:]

TESTIMONY OF CHRISTOPHER W. BRODY, ON BEHALF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION, BEFORE THE COMMITTEE ON WAYS AND MEANS U. S. HOUSE OF REPRESENTATIVES

Wednesday, January 25, 1995

Hon. Chairman and Members of the Committee:

Good morning, my name is Christopher Brody and I very much appreciate the opportunity to testify this morning before the Ways and Means Committee with respect to legislation to significantly reduce capital gains taxes.

I am a member of the Board of Directors of the National Venture Capital Association and Chairman of its Committee on Taxes and Incentives. I am a partner of Warburg, Pincus and Company, and have been a full-time venture capitalist for more than twenty-five years, during which period our firm has provided long term equity capital to over two hundred businesses. Our firm has over one hundred employees dedicated to venture capital; over fifty of the employees are professionals, twenty-eight of whom are highly experienced partners in the firm.

We are often asked, "What is venture capital?" In its simplest definition, I believe that it is the process of providing both long term, patient, risk equity capital, with the substantial human resources of the venture capitalist working on an on-going basis with portfolio companies to help them achieve their goals. Venture capital portfolio companies are generally privately held at the outset, although, in many instances, the companies to which we provide equity capital can be publicly traded.

Venture capital includes the following characteristics:

- We provide equity capital as long-term investors, in partnership with management, infriendly transactions.

- We are actively involved, not only in assembling and organizing the capital in partnership form, and in making investments in portfolio companies, but in making a substantial commitment in human resources. We work closely with the management team, generally at the level of the board of directors and, while usually not involved with management on a day-to-day basis, are extremely active in reviewing strategy, key personnel decisions with respect to the senior management (personnel assessment, recruiting, and compensation), and key financing decisions, as well as identifying other important missing resources and helping obtain them. Sometimes we may serve as Chairman of the Board or Chairman of the Management Committee of our companies. The venture capitalist's commitment is always time intensive, whether the investment is successful or not.

- We are not investment bankers, we do not take transaction fees, and we are only successful economically if our portfolio companies are successful. Generally our capital is raised in partnership form, provided by limited partners, in a partnership which will make twenty to fifty investments over a four to six year period, providing diversification of risk as a result of being done in a portfolio fashion. The investments, when made, may be held as long as ten to twelve years (but more generally five to ten years).

The venture capital process in the United States is the envy of foreign countries, many of whose key ministers have often approached us to explain this "great success of venture capital in the United States". The basis of our response is that the development and success of venture capital in the United States had been based upon four elements, which are:

1. The availability of risk funds to go into the industry, both formal firms and informal ("the angels" alluded to in earlier testimony);

2. The development of highly experienced professionals (i.e., venture capitalists) dedicated to the management of commingled funds (primarily in partnership form);

3. The ability of these portfolio companies to raise capital, not only from venture capitalists, but subsequently from public markets to further finance growth, and ultimately enable investors to exit profitably;

4. And last, but certainly not least, the development of the entrepreneur with extremely strong incentives for management and employees to build these portfolio companies

Success and low capital gains rates reinforce each of these elements.

These four elements have developed dramatically over the last two to three decades as venture capital has developed in the United States. What is particularly potent about these four elements is that the incentives for each can be most forcibly stimulated by lower tax rates on capital gains than the tax rates on ordinary income such as interest or dividends. The reason for this is that from the point of view of the investor of risk capital, there is no interest income (because this is equity not debt) and there are generally no dividends (because high growth companies need to retain their profits and re-invest them in their businesses in order to finance growth, and therefore cannot pay dividends), and from the point of view of entrepreneurs, they may very well have left a safer, higher paying job in taking the risk to build the company. But, if successful (and for every large success there are many failures), the reward for all involved will be capital gains.

These four elements reinforce each other, and success reinforces success. If you want to stimulate this important segment, you must do it with low long term capital gains rates and a significant differential to ordinary income tax rates -- capital is highly elastic and there is lots of competition for places for it to go.

What I would like to do this morning is to describe a specific investment; it happens to be a transaction which, at least to date, has been very successful. Because most investments do not work out this well, either for the investors or for the management and employees, when they do, the opportunity to be able to retain (on an after-tax basis) the benefits of such success is extremely important, and the willingness to take such risks is significantly enhanced by the capital gains rate structure in this country.

Anatomy of a Successful Investment

In mid-1989, our firm was approached by a husband and wife entrepreneur team who had written software code which would enable users of the product to prepare their tax returns on PC's. The husband had initially written the product in order to prepare his own tax return (he had been a programmer at a large company), and had made it available to friends who advised him that it was better than anything else on the market. His wife quit her job as a school teacher and literally started the shipping department for the company by opening their garage door and recruiting friends to help wrap and package the product for shipping during the peak portion of the tax season. The name of the product was Turbo Tax, and the name of the company was ChipSoft.

At the time of our investment, ChipSoft was essentially a tax software product, rather than a company. While its product sales were growing rapidly, its product was based upon old technology, and ChipSoft had no management or business infrastructure, and had outgrown the capabilities of its founders, who were completely stressed out and wished to retire. When we arrived, the company had no marketing department, inadequate resources to rapidly update the product each year as tax regulations changed, no business plan or strategy and operational problems which were so severe, that I remember at one of our visits to the company, the computer that kept track of all operations and shipping crashed three times in one morning.

The commitment that we made to the founders was that we would buy a majority stake in the company. The founders retained 18% of the company, and another, eventually nearly 20%, was set aside for management and employees. We also committed to share responsibility for management until we succeeded in recruiting a CEO, as well as to continue to guide the company going forward, so that it could transition from essentially being a very successful product with great potential, into becoming a professionally managed business with a top flight management team.

The company had been run as a sole proprietorship, by which I mean that other than the two founders, no one else owned any stock in the company. We realized that, in order to be successful in the long run, the culture of the company had to be changed, and people who were already stretched would have to be motivated to work incredible hours, for which incremental cash compensation was not available, nor adequate. Accordingly, we decided that every person who was in the employ of the company on the day we made our investment (some 60 full-time employees, many of whom had lower level jobs) would receive stock options in the new company. Today, those options, together with additional shares which were subsequently issued to attract and recruit additional people to the company, have an aggregate value of $80 million.

Between our first meeting with the founders and the date of our investment, we spent six months doing due diligence, helping the company and negotiating the transaction. During this six month period, before we had even made the investment, three of us from our firm (one of my partners, an associate, and myself) had already :

- Conducted a market research survey of the industry (which was at a very early stage);
- Drafted a strategic plan for the company;
- Recognized that because the company served two very different markets and, notwithstanding its excellent common core technology, therefore had to be divided into two divisions: one which served the professional tax preparer (a total potential market of some 200,000 tax preparers in the United States), and one which would serve the very rapidly growing market of people who had personal computers in their homes;
- Designed an organization chart for the future, and laid out a recruiting plan for the company; and,
- Negotiated and structured the investment.

While one might think that the six months that we worked on this transaction between the time we first met the founders, and closed on the investment, was intense, our work, and the pressure really started the day after we closed, because now, it was not just their company, but also ours.

While we immediately set out to recruit a top flight Chief Executive Officer, it was another six months before our firm had identified and recruited the individual, a man who had been President of a large industrial company. In the meantime, one of my partners ran the company with the founder. Because the company was already in the middle of the tax season, we paid a consulting firm to temporarily staff the marketing department, until we could recruit one.

Over the next three and one half years of our investment (early 1990 to mid-1993), working closely with the new CEO, we undertook the following changes:

- Recruited an additional six key individuals for the top management team, which included: division general managers for the two newly created divisions, a vice president of marketing, a vice president of finance, a vice president of operations, and in order to prepare to become a $100 million business, a chief operating officer, who was already COO of a large publishing company.

Two of the things that motivated these people, most of whom had left higher paying, safer jobs, with larger companies, was the challenge of participating in successfully building a rapidly growing smaller company, and secondly, the equity incentives through stock options, if they were successful.

- Recruited a world class Board of Directors for the Company, which included the former head of operations of a $10 billion computer company, as well as a man who had recently retired as president of Microsoft.

  Because the company could not afford significant directors' fees in cash and as an incentive for their heavy involvement as members of the Board of Directors, none of the directors received any cash compensation, but they did receive, or had the opportunity to purchase, stock in the company. These directors have been extremely and actively involved in helping the company.
- Helped the company use its common shares to make two acquisitions: one, a company, which, while floundering, had more technologically advanced MAC and Windows software products (which were then rewritten and upgraded by the ChipSoft for its customer base), as well as another, also floundering company, which had technology which would enable ChipSoft to offer electronic filing capability to its customers. While both of these acquired companies were in financial difficulty, ChipSoft could not have purchased them for cash because: (a) it could not pay the required purchase price in cash, (b) it wanted the founders of the acquired companies to be motivated on an on-going basis, and (c) because the sellers wanted stock in order to participate in the upside of the combined companies.

- In April, 1992, we identified and negotiated with underwriters for an initial public offering, which raised capital to finance the further growth of the business. The IPO was not an "exit for the investors", but served to raise capital to further grow the business.

- By mid 1993, it was clear that the marketplace and product offerings for personal finance products in the home would be consolidating, and that it was extremely important that a tax product could interface easily with other home finance products such as checkbook management. ChipSoft had a marketing partnership for many years with a company called Intuit, whose personal finance product, Quicken, was also a market leader in its category. (Turbo Tax was the market leader in the personal tax market.) It was clear that if these two companies combined, they would be able to offer a stronger, and better integrated product line to their customer base, as well as enjoy the benefit of more efficient operations, be able to offer better technical support for their customers, as well as having greater resources for future product development. Because of the large market values of both companies relative to their cash resources, as well as the unconditional requirement of both sides to get the full benefit of participation in the combined companies, the merger had to be done completely in common stock. Accordingly, at the end of 1993, ChipSoft and Intuit combined, creating a company which was doing over $200 million in sales and continued to have substantial growth potential.

The Intuit story is a somewhat similar, and also interesting story. At approximately the same time that the founders of ChipSoft were inventing a tax product (the mid 1980's), a young marketing consultant, and some colleagues, set out to design simple-to-use software which would enable the users to manage their personal finances, primarily oriented around the checkbook. By mid-1993, the company was doing approximately $100 million in revenues. Also, like ChipSoft, Intuit had been founded with "informal venture capital", or private savings from individuals, and later had benefited from the extensive involvement of two venture capitalists on its Board of Directors, and had also gone public through an initial public offering.

The Aftermath

Today, the combined companies, both of which were total start-ups in the 1980's, are operating at a $350 million annual sales rate, employ 1,200 full-time employees in operations located on the west coast, midwest, southwest, and southern part of the United States, serve some 4 million home users, as well as thousands of small businesses with their accounting software, and are now starting to generate significant revenues from international exports of their technology as well. This combined company is also going to be a very significant federal, state and local taxpayer. We believe that the company has enhanced the productivity of its customers, both individuals preparing their tax returns and managing their other personal financial affairs, as well as the many small businesses which are using the product for taxes and accounting.

Although the amount of work (which can be measured in "man years") required before an investment is made is substantial, an even greater commitment of human resources by the venture capitalist is required after the investment is made. What has been described is a successful deal, but I think you can imagine that, when companies are not successful, or continue to experience significant problems on an on-going basis, the venture capitalist's commitment of time is also intensive, but not as gratifying.

The purpose in describing this story to you is to convey, by example, that when venture capital is successful, it creates jobs, it can develop new products and technology, it generates potentially large corporate taxpayers, it enhances international competitiveness, and it can improve the quality of life.

The Potential Effect of Capital Gains Tax Rates on the Process

This has obviously been a very successful experience for the founders/entrepreneurs, the professional management who left secure positions in larger companies, the employees who had stock options, the members of the Board who received stock rather than cash compensation for their time, and the founders and entrepreneurs of the companies who were merged into ChipSoft and Intuit. And, of course, this has also been a very successful investment for the investors: the original informal backers, the venture capitalists and their limited partners, and the shareholders who acquired their interests in the IPO and subsequent public trading market, without all of whom this could not have happened as it did.

What they all have in common is that, in varying degrees, they all took risks because they were motivated by potential capital gains, and because they were successful, were rewarded.

While I would like to reiterate for every big success, there are many failures, this type of story has happened in the United States in many industries. In the computer hardware industry, Apple Computer and Intel Semi-Conductor were both venture capital backed companies, and without the PC and the micro-processor chip, ChipSoft and Intuit would never have followed.

This type of success can happen many times again. And if you want to nurture and encourage this venture capital/entrepreneurial advantage which we have in the United States, please significantly reduce real capital gains tax rates - this is capital gains rates net of all potential adjustments such as AMT, preference items, etc. In doing so, you are focusing on the essential economic reward of the entrepreneur and investment risk taker.

One final caveat which I would like to leave in closing. A 50% or some other dramatic reduction in capital gains rates would have a significant and salutary effect on the venture capital/entrepreneurial process. In the past, this has, at one point, been coupled with making the exclusion a preference item for AMT purposes. We have submitted, as part of our written testimony, some calculations which show that if such a notion were to be implemented, it would essentially take away any benefit of a reduction in capital gains rates; please bear in mind that the entrepreneurs and investment risk takers hope they will be extremely successful, which, if they achieve success, will almost, by definition, mean that they will create large capital gains which will put them in the AMT. Any AMT adjustment which takes away the advantages of a long term capital gains tax rate reduction would eliminate the incentive which you are trying to achieve. I know this is not what has been intended.

Again, I want to thank you for giving our industry an opportunity to testify today at your hearings. We also appreciate the recent efforts of Congress in enacting lower capital gains rates for qualifying small businesses. Our message today is that a broader approach towards capital gains reduction would have an even greater, and more important, impact on the entire venture capital/entrepreneurial process. And let me be clear, the tax treatment for an investor who invests in one of these companies after it has been successful and gone public is also important, because if the tax treatment is favorable, he or she can afford to pay a higher price and has a greater incentive to invest, which pulls along the entire valuation train, and provides greater incentives and opportunities, for those involved throughout the train, including at the beginning.

I hope we have been able to convey to you what we do, how we are involved with our companies, and how important your deliberations, and the outcome of your deliberations, can be on the venture capital/entrepreneurial process in this country. If any of you have any questions, I would be delighted to answer them now, or later if you wish. Again, thank you very much.

HOW AMT TREATMENT OF CAPITAL GAIN AND INVESTMENT EXPENSES IS VITAL TO OBTAINING BENEFIT OF CAPITAL GAINS REDUCTION

At present, individuals who live in high tax states and have substantial capital gain income in relation to ordinary income are generally taxed under the alternative minimum tax ("AMT") instead of the regular tax. This occurs even though the maximum AMT rate and the maximum capital gain rate are both 28 percent, because deductions for state and local taxes and for investment expenses (i.e., section 212 deductions above the 2% floor) incurred to produce the capital gain are denied for purposes of determining the AMT.

If Congress reduced the capital gains rate, but made the reduction a preference for AMT purposes, the benefit of the reduction would be eliminated for most taxpayers who incur significant capital gains. For example, if Congress were to enact a 50 percent capital gain exclusion, the effect of the exclusion would be to reduce the maximum capital gains rate under the regular tax to 19.8 percent (50% x 39.6). However, if the capital gains exclusion were made a preference for AMT purposes, individuals who have significant capital gain income will continue to be taxed at the 28 percent rate under the AMT -- receiving no benefit from the enactment of the 50 percent exclusion. This will be equally true for both small entrepreneurs, who receive a one-shot capital gain as the result of the sale of a business, and for venture capitalists.

Furthermore, as illustrated by the following examples, if making the exclusion an AMT preference is combined with the present law rule denying the deduction for investment expenses, venture capitalists who receive capital gain income will be taxed at rates well in excess of the top 39.6% rate on ordinary income. (These examples assume the investor has enough ordinary income to reach the 39.6% rate.)

> <u>Current law.</u> If an investor has a $100,000 capital gain and a $30,000 investment expense (in excess of the 2% floor) incurred to produce the gain, the investor will be taxed on his $70,000 net gain under the regular tax and (assuming the maximum 28% rate applies), will pay $19,600 of tax. However, under the AMT, the investor is taxed at the 28% rate on the $100,000 gross gain, and must therefore pay $28,000 of tax. This translates to a 40 percent tax on the net gain earned from the investment.

> <u>50% Capital Gains Exclusion as Preference.</u> If Congress were to enact a 50% capital gains exclusion, but make it a preference for AMT purposes, investors with significant capital gains would inevitably be subject to tax under the AMT and would thus receive no benefit from the reduction in capital gain rates. For example, a taxpayer with a $100,000 capital gain would receive a $50,000 deduction for regular tax purposes. However, the $50,000 would be added back to income for AMT purposes, making the investor taxable on the entire $100,000 gross capital gain at the 28% top AMT rate -- essentially no change from current law. This consequence would be exacerbated if Congress retains the current law treatment denying the deduction of investment expenses for AMT purposes, because -- as shown above -- the investor will be taxed on gross, rather than net, capital gains -- causing investors to bear taxes substantially in excess of 28% on their net capital gains and defeating Congress' objective in lowering the maximum regular tax capital gains rate to 19.8 percent.

Chairman ARCHER. Thank you, Mr. Brody.

Our next witness is Amaury Piedra of NeoCAD in Boulder, Colo. We welcome you and you may proceed.

STATEMENT OF AMAURY PIEDRA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NEOCAD, INC., BOULDER, COLO.

Mr. PIEDRA. Thank you, Mr. Chairman, and members of this distinguished committee. Good morning. Thank you for the opportunity to appear before you today.

I am Amaury Piedra, president and chief executive officer of NeoCAD of Boulder, Colo. I am appearing before you this morning in that capacity. NeoCAD develops and markets design automation software directed at a certain class of semiconductor electronic components. These components are programmed in the field by the hardware design engineers who are implementing digital functions in computers, telecommunications equipment, instrumentation, in fact, across the whole spectrum of electronic systems.

Founded in November 1990, we already have 60 employees and about 40 percent of our revenue comes from outside the United States. NeoCAD truly is one of the Nation's high technology startups which will lead American business into the 21st century.

All NeoCAD employees have stock options, there are no exceptions. From the receptionists and the shipping clerk all the way to the chief executive officer. This gives everyone a sense of ownership and interest in the future of the company. It creates a healthy long-term view inside the enterprise. We expect to continue to grow employment at 10 to 15 percent per year over the foreseeable future and to go public in the next 18 months.

Mr. Chairman, I am here to talk about the capital gains tax provisions in the proposed Job Creation and Wage Enhancement Act, a reduction. A significant reduction in the capital gains tax will stimulate the formation and investment of long-term risk capital which will result in many benefit streams.

A significant reduction in the capital gains tax will shift money tied in passive investments to new job creating ones.

I have submitted a written statement to the committee explaining the many reasons why I am a strong supporter of the capital gains tax cut and indexation for inflation. NeoCAD was founded with venture capital from Hill & Carmen Ventures, a venture firm founded in Boulder and Institutional Venture Partners of Menlo Park, Calif., one of the deans of venture capital partnerships. During the past 4 years, 60 jobs have been created, 60 high-paying jobs averaging over $56,000 a year, jobs which did not exist 4 years ago.

NeoCAD is just one small example in many of risk capital availability helping to create jobs.

Not every potential venture is as fortunate as NeoCAD and gets financed particularly by top flight investors.

That is why I am here today. As an entrepreneur, I have also seen the ugly side of a startup business, when money is not available to grow. Just before joining my present company, I was president and chief executive of Seattle Silicon Corp. in Bellevue, Wash.

Seattle Silicon was in the business of selling custom chips and automation software for chip design. It was an excellent technology but, because of insufficient patient risk capital, we had to sell the design automation business to Ichi Electric of Japan. This was a devastating experience with lost jobs and lost technology. Now, because of lack of capital, a Japanese company owns a great technology which we should have been exploiting and exporting.

Investors have certain criteria which they follow in financing a new company. If the tax on the capital gains returns was lower, capital would be more patient and more available. Some of our brightest potential companies would not have to sell to foreign investors who have an eye on the startups' technologies and intellectual property portfolios.

There are no guarantees, but if the capital gains tax had been lower in 1991 when we sold Seattle Silicon, we may have gotten additional capital because capital is a lasting response to the supply and demand. The capital gains tax is a tax against those trying to achieve. Most of these are not rich but want to be. It is a tax against risk taking and entrepreneurship.

Mr. Chairman, long-term risk capital availability is essential to economic growth. The lack of it results in ideas not being turned into products and services, lost jobs and loss of competitiveness. The issue we discuss today is simple. If we want broader participation in the economy, and greater growth, we have to create more jobs. More employees means more employers. We want more employers. We need more risk capital. To make more risk capital available, we have to cut the tax on capital gains and index those gains for inflation.

Thank you very much for inviting me to share some of my thoughts on this most critical issue before the country.

[The prepared statement follows:]

TESTIMONY OF AMAURY PIEDRA
NeoCAD, INC.

Mr. Chairman and Members of this distinguished committee -- good morning. Thank you for the opportunity to appear before you today.

I am Amaury Piedra, President and Chief Executive Officer of NeoCAD of Boulder, Colorado. I am appearing before you this morning in that capacity. NeoCAD develops and markets design automation software directed at a certain class of semiconductor electronic components. These components are programmed in the field by the hardware design engineers who are implementing digital logic functions in computers, telecommunications equipment, instrumentation, in fact, across the whole spectrum of electronic systems.

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We expect to continue to grow employment at 10% per year over the foreseeable future and to go public in the next 18 months.

Mr. Chairman, I am here to talk about the capital gains tax provisions in the proposed Job Creation and Wage Enhancement Act.

A reduction in the capital gains tax will stimulate the formation and investment of long-term risk capital which will result in many benefit streams. A significant reduction in the capital gains tax will shift money tied in passive investments to new job-creating ones.

So, Mr. Chairman, I am here to discuss how a capital gains tax cut and indexation for inflation will help create jobs, improve our competitiveness in the global market, grow the economy and improve our standard of living.

We all recognize the names: IBM, Boeing, Sears, General Motors. What these companies have in common is downsizing. Business conditions are such that the large American enterprises will continue to cut jobs. It seems that this will be the reality in the American job market in the foreseeable future. In the first half of 1993, a net 255,000 jobs were identified for elimination in the U.S., mostly by large U.S. companies.

Job creation will depend on the small, entrepreneurial emerging growth companies. These companies were the job creation engine in the last decade, creating about 17 million jobs during a time window when large U.S. enterprises eliminated about 4 million jobs. The near future augurs for more of the same.

The reasons for the corporate downsizing, layoffs and reorganizations are many, but one of the key ones is that, by any measure of efficiency and productivity such as innovation per R&D dollar, revenue per employee, overhead costs, new products per development dollar, dollars to create a job, time to market, etc., small entrepreneurial companies, "the gazelles" of American business, compare very favorably with the large enterprises.

A recent book by John Case (*From the Ground Up: The Resurgence of American Entrepreneurship) contains the following table.*

FORTUNE 500 EMPLOYMENT HISTORY

YEAR	EMPLOYMENT (MILLIONS)	% OF GNP
1954	8	37
1959	9	40
1969	15	46
1979	16	58
1989	12.5	42
1991	11.9	40

The table illustrates the emergence of the entrepreneurial growth companies as the dominant factor in GNP value, and this, at a time when small farm enterprises are on the retreat.

In spite of the evidence in favor of the entrepreneurial emerging-growth companies, our system of taxation continues to favor large companies with physical assets which can be used as collateral to obtain debt financing. The service of this debt is, of course, deductible as an expense of the enterprise in the income statement.

If small entrepreneurial companies are to create jobs, we must have capital available for these companies to emerge and grow. This capital must be in the form of equity, because these small enterprises do not have the hard assets required as collateral by the commercial lending institutions. The capital which goes into the creation and growth of these entrepreneurial companies must be in the form of long-term equity investments.

This type of investment represents uninsurable risk -- there is no collateral. Investments in the emerging growth companies are in people, ideas, innovation, potential future intellectual property and potential future products.

To make sure there is enough long-term risk capital to fuel the jobs engine, we must provide incentives to create that capital. A cut in the capital gains tax, creating a significant differential from regular income, will create an unprecedented investment climate and boom in investments in innovative enterprises which will create an explosion in new jobs. The benefits to the economy would be of historic proportions.

A 1993 study by Gary and Aldona Robbins of the Institute for Policy Innovation calculates that only indexing gains for inflation at that time would have created an additional 550,000 jobs, would add $511 billion to the GDP and increase capital formation by $1.8 trillion -- all by 1997.

Reductions in the capital gains tax have always resulted in increased tax revenues to government. The following table shows the irrefutable historical data:

Year	Capital Gains Tax Rate	Taxes Paid (in millions)	Capital Gains Income
1977	48%	$8.104	
1978	28%	9.104	
1979	28%	11.669	Tax Cut
1980	28%	12,459	
1981	28%	12,684	
1982	28%	12,900	Tax Cut
1983	20%	18,500	
1984	20%	21,800	
1985	20%	26,478	
1986	20%	49,700	
1987	28%	32,941	Tax Increase
1988	28%	38,963	
1989	28%	35,769	
1990	28%	27,829	
1991	28%	24,505 *	

* Estimate - American Council for Capital Formation
Source: U.S. Treasury Department

The data presents a clear-cut case for reducing the capital gains tax just from the standpoint of tax revenues. Coupled with the employment data, it makes for a powerful argument in support of such a tax cut. Every time the tax rate has gone down, investments have increased and so have capital gains realizations and taxes on those gains. In contrast, the capital gains tax rate was raised to 28% from 20% in 1986. 1986 taxes on capital gains were very high as people realized gains before the tax increase went into effect in 1987. So, 1986 was an unusual year, but, if we look at 1985, taxes from capital gains were higher than today.

There are $7 trillion or more in the U.S. of unrealized capital gains. Of that, $1 trillion is real and the balance of $6 trillion is from inflation gains. Private assets unencumbered by debt represent about $19 trillion today. The largest element of this money is homeowner's equity. By cutting the capital gains tax rate and indexing the gains for inflation, an enormous amount of capital would be freed up from present passive investment and become available to fund new and growing companies. The freed up capital would reflow into new enterprises. These companies would create jobs and economic prosperity. With the potential to borrow against unencumbered assets and invest that money in new businesses with the promise of capital gains under reduced tax rates would result in an increase in capital gains tax revenues, a broader taxpayer base and increased productivity and competitiveness for U.S. businesses. The tax cut would create an investment boom which would push the economy to new levels undreamed of under the present tax structure and rates.

Mr. Chairman, the capital gains tax cut has been attacked by some as "trickle down economics" and a give-away to the rich. This is a dishonest representation.

Let's consider the first accusation -- "trickle down economics." First of all, there are no capital gains until an investment has been made and people have been hired. If the enterprise is successful -- and this is far from guaranteed -- then there is the possibility of capital gains realizations. The benefits have been realized by those employed before the investors can reap any benefits. So where is the "trickle down"?

The second characterization of the capital gains tax cut is that it is a give-away to the rich. There is no question the rich will benefit. However, so will many others. One of the many studies available on the subject we are discussing today showed that 70% of the tax returns reporting capital gains in 1990 were for taxpayers with incomes of less than $75,000. The exact same group which the most vocal political critics of the capital gains tax reduction say they want to help.

The majority of capital for new ventures comes informal investors rather than from professional venture capital. Institutional venture capital represents less than ten percent of money for new ventures. According to a study by the Small Business Administration, in 1988, informal investors supplied businesses with $55.6 billion of capital. This compared to $3.7 billion from institutional venture firms. Further, in the highly visible high technology arena, a 1990 survey by the American Electronics Association, the National Venture Capital Association and Coopers and Lybrand (a public accounting firm) indicates that 54 percent of all these firms got their original financing from founders, their families, friends or other individuals. Once these companies begin to grow, they become attractive to institutional investors who generally invest larger sums.

The capital gains tax is really a tax not on the rich, but on those who try to make a hard fought profit for themselves and their investors. It is a tax on entrepreneurship.

In addition to the distorted view of the capital gains tax cut given by its critics, there is a large element of unfairness in this tax. The main sources of capital gains are inflation and retained earnings. Inflation gains are totally artificial -- on paper only, not in real terms. The taxation of these artificial gains is not taxing real income. This taxation should not happen.

Retained earnings have been taxed at the company level. Taxing the capital gain from this source twice is hardly conducive to encouraging re-investment.

The existing tax system has forced business owners, homeowners, workers and farmers to "lock in" their assets rather than pay high capital gains taxes on mostly artificial gains and retained earnings. This prevents the movement of capital from passive to active, job-creating investments. In addition, capital continues to be exported to countries such as Germany, Holland, the United Kingdom or Japan, where capital gains taxes are much lower than ours or non-existent.

A meaningful reduction in the tax on capital gains can do more to stimulate the economy than most of the single tax tweaks more frequently proposed.

A great opportunity is in front of us to reduce, or even better, eliminate the capital gains tax. For the good of the country, we must act against this opportunity-destroying, counterproductive tax.

A cut in the capital gains tax will encourage long-term investment in new ideas and growth enterprises as well as create employment. Long-term thinking is something which we have long admired in Japan and short-term thinking something for which we are self-critical. This proposed tax chaange will improve exports and make our technologies and products more competitive in the global market.

Just as important as cutting the capital gains tax is leaving the tax cut in place.

We must have a stable, long-term investment infrastructure to ensure ideas will become products and services and add value to the economy.

Most start-ups are high risk for the principals who leave jobs to start their companies. In addition, many entrepreneurial companies must attract experienced management to grow. These managers are usually in high-paying jobs and one of the few ways in which they are attracted to start-ups is through stock options and the potential of capital gains over the long term. It is more attractive to these people if they know the taxes on this type of gain are low and will remain that way.

If we are to have greater and broader participation in economic growth and improved standard of living and greater economic freedom, we have to have capital. We must create the environment for investors to put capital at risk -- long term.

Mr. Chairman, the issue which we discuss today is relatively simple.

If we want growth, we have to have more employees. If we want more employees, we need more employers. If we want more employers, we need more risk capital. To make more risk capital available -- new capital or reflowing from old, passive investment -- we have to cut the capital gains tax and index capital gains for inflation.

Thank you for inviting me to share some of my thoughts on this most critical issue for the economic well being of our nation.

Chairman ARCHER. Thank you, Mr. Piedra. And thank you also for complying precisely with the 5 minutes. The red light came on just as you finished, so I am grateful for that.

Our next witness is John Chapoton, who is a counsel for the Alliance for Business Investment. A gentleman who is not unknown to this committee, because you have sat out there in a different capacity before.

We are pleased to have you as a witness and you may proceed.

STATEMENT OF JOHN E. CHAPOTON, COUNSEL, ALLIANCE FOR BUSINESS INVESTMENT

Mr. CHAPOTON. Thank you, Mr. Chairman. It is a pleasure to be here. As you said, my name is John Chapoton. I am a partner with the law firm of Vinson & Elkins. I am appearing today to give you the views of the Alliance for Business Investment in support of the reduction of the Federal income tax on capital gains.

The Alliance for Business Investment is an association of money center commercial banking corporations actively engaged in the business of providing significant amounts of equity venture capital to small- and medium-sized emerging companies. The members of the Alliance provide this equity capital through subsidiary corporations, either subsidiaries of bank holding companies or SBICs, small business investment companies.

I will be very brief. The most important message I want to convey today is that corporations as well as individual pension funds and other tax-exempt institutions are vital sources of venture capital in the market today.

A December 1994 study by Asset Alternatives, Inc., which is a specialized information research firm located in Wellesley, Mass., has found that commercial banks now have more than $5 billion invested in venture capital and in recent years have provided between 6 and 13 percent per year of the total amount of new venture capital invested by all professional venture capital firms.

It is therefore essential that this committee, in providing incentives for growth in business productivity and the jobs that are created as a consequence, reduce taxes on capital gains from corporate investment in the same manner as investment by individuals. And the proposal before you, Mr. Chairman, does that. And we strongly support it.

I should add that, in this regard, the treatment is consistent with the traditional treatment of capital gains of individuals and corporations—or at least traditional before 1986, that is—both have been given a lower rate of tax.

The importance of the banking industry in the venture capital business is reflected in the success of the companies that begin their life in part or totally because of capital provided by banks. I list them in my statement. They are companies that you would know such as Federal Express, Compaq, James River Paper, Somerset Pharmaceuticals which developed the anti-Parkinson's drug L-Deprenyl, Celestial Seasonings, Gymboree, and many others.

The important message, again, is that corporations play the same important role as individuals in creating these and other growth-related industries and making job creation a reality.

I think the role of corporations is not as well understood in the venture capital area. Banks and other financial institutions do play an important role. These include insurance companies and industrial companies, particularly those involved in high technology industries or in the venture capital business. Most larger U.S. banks, over 50 banks in this country, have separate venture capital subsidiaries and the total value of their equity commitment is considerable.

In the last 10 years their venture capital investment has grown, some tenfold, as I mentioned, to $5 billion, a meaningful portion of total venture capital. And the contribution they make exceeds the size of their participation because they represent a substantial source of venture capital that provides a cushion when other sources of venture capital dry up.

For example, in the period 1987 to 1991, there was a substantial decline in the amount of new venture capital available in the market. It fell to only $1.4 billion when venture capital fell out of favor with pension funds and tax-exempt organizations which had been the traditional providers of capital to venture capital firms. But bank capital investment actually increased in that year and, indeed, in 1991 accounted for 13 percent of the total investment by venture capital.

I must mention there are bank regulatory restrictions on investments by bank subsidiaries in venture capital, but there is still a lot of room for growth. A very small portion of total bank assets is dedicated in this manner, but the results are very favorable and they do respond very actively, as most investors do, to increased rates of return on investment. And of course the way to do that is by lowering the capital gains rate.

I finally mention as a tax policy concern, Mr. Chairman, as you know, that investments through corporations are taxed very heavily in this area. This is certainly no exception. You really have three levels of tax on venture capital investments through corporations and this acts as a significant disincentive to venture capital investment by banks and by other corporations. A reduction in the rate of capital gains tax on the corporate venture capital side or on the general capital gains side and the venture capital side in particular certainly would be appropriate and certainly would remove a disincentive to an otherwise economically desirable activity.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF
JOHN E. CHAPOTON
ON BEHALF OF THE
ALLIANCE FOR BUSINESS INVESTMENT
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

January 25, 1995

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Alliance for Business Investment in support of the proposed legislation to reduce Federal taxes on capital gains contained in H.R. 9, the "Job Creation and Wage Enhancement Act of 1995." I am the Managing Partner of the Washington Office of Vinson and Elkins, L.L.P., a law firm based in Houston Texas, and I serve as counsel to the Alliance.

The Alliance is an association of money-center commercial banking corporations actively engaged in the business of providing venture capital to small and medium-sized emerging companies through wholly-owned venture capital subsidiaries. The members of the Alliance have made major commitments to support new businesses and products by making available needed equity venture capital. Banks are in a unique position to provide needed venture capital to emerging, growth-oriented companies.

The importance of the banking industry in the venture capital business is reflected in the success of the companies in which they have invested. Some of the better-known companies that began life in whole or part with bank venture capital include Federal Express, Compaq Computer, James River Paper, Ethan Allan Interiors, Office Depot, Nextel Communications, Morris Air (now part of Southwest Air), Thermoscan, Somerset Pharmaceuticals (developer of the anti-Parkinson's drug L-Deprenyl), Staples, Celestial Seasonings, and Gymboree, to name just a few.

The most important message I would like to convey today is that corporations, as well as individuals, are a vital source of venture capital. A new study of the venture capital market by Asset Alternatives, Inc. has found that commercial banks have more than $5 billion invested in venture capital and in recent years have provided between 6 and 13 percent of the total amount of new venture capital invested each year by all venture capital firms. It is therefore essential that this Committee, in providing incentives for further growth in new businesses and products -- and the jobs that are created as a consequence -- reduce taxes on corporate investments in the same manner as on investments by individuals.

Needless to say, the Alliance strongly supports the current proposal, which does just that.

The Effect of Reducing Taxes on Capital Gains

I will not take the Committee's time reiterating the benefits to the economy of a reduction in Federal taxes on capital gains. Others, including a multitude of eminent economists, have catalogued these benefits over the years and in these hearings, and the positive effects of such changes are well known to the Committee. One of those positive effects is, of course, job creation. The Asset Alternatives study just referred to credits bank venture capital investments with the creation of 80,000 new jobs over the last ten years.

A reduction in the tax on earnings from savings -- in the manner provided in the legislation for capital gains -- will clearly increase the incentive to save, and therefore the amount saved and invested. An increase in savings and investment will in turn increase the rate of economic growth and foster job creation.

The Importance of Venture Capital

Venture capital is a particularly powerful force for economic growth. The National Venture Capital Association has testified about the importance of venture capital for emerging companies, and their job-creation potential. I would add that, according to a study prepared for the Small Business Administration, a new job is created for every $17,000 of venture capital invested. It is difficult to believe that there could be any more efficient use of savings for growth. We strongly support the proposed reduction in capital gains taxes; it would significantly increase the amount of available venture capital.

The risks involved in venture capital investments are substantial. The recipients of this type of capital are frequently companies with little or no operating history and virtually no sales; they may never have generated any earnings. All they have is an idea or a product, and a plan to exploit it. It should not be surprising that investments in a very large percentage of these companies result in losses, frequently total losses.

We are not talking now of what may be called "seed" money, the initial capital (usually less than $1 million) needed by an entrepreneur at the outset of the enterprise. That initial seed capital is usually too small an amount to attract the professional venture capital investors, although professionals occasionally become involved at the start-up level. Instead, we are talking about the next stage of investment where venture capital is needed to bring a new product or idea to market or to expand into new markets, and where substantial amounts of capital are generally needed. It is at these stages that corporate venture capital investors, along with other institutional investors and venture capitalists, provide the necessary wherewithal to give the new venture a meaningful chance.

We are also talking about cases in which bank venture capital companies help firms that have reached maximum potential with their current management or capital to expand and grow. They do this in a variety of ways, including the introduction of new capital and financing structures.

The Role of Banking Corporations in the Venture Capital Market

The role of individuals in providing venture capital, either directly or through professionally managed funds, is well known. Most of us are also familiar with the important role of pension funds and other tax-exempt institutional investors.

Less familiar, I believe, is the increasingly important role played by corporations. Bank affiliates and other financial institutions are actively engaged in the venture capital business. Many insurance and industrial companies, particularly those involved in high-technology industries, also in the venture capital business.

Most of the larger U.S. commercial banks have venture capital subsidiaries. These are nonbank corporations, which do not invest depositor funds, but instead obtain funding from the parent bank holding company. In fact, over 50 U.S. commercial banks operate venture capital subsidiaries today. And the total value of their investments in venture capital is considerable. In the last ten years, bank venture capital portfolios have increased ten-fold in value, to nearly $5 billion. This represents a very significant portion of total venture capital currently invested in the United States.

Moreover, the importance of banks in the venture capital market exceeds the mere size of their participation. Banks represent a stable source of venture capital that has provided a cushion during periods when other sources of capital have contracted. Independent venture capital firms must constantly go to the market to seek funds from individual and institutional venture capital investors. The venture capital subsidiaries of banks, in contrast, obtain funds from their parent banking companies, with their many and diversified sources of funds. This enables banks to be more consistent, long-term players and makes them less subject to the fluctuations in the availability of venture capital funds.

For example, the 1987 to 1991 period was marked by a substantial decline in the amount of new venture capital available to the market -- to only about $1.4 billion -- when venture capital investment fell out of favor with pension funds and other institutions that provide capital to independent venture capital firms. Bank venture capital investments, on the other hand, actually increased during this period. In 1991, in fact, venture capital provided by banks accounted for 13 percent of the annual total amount invested by capital venture firms.

Bank venture capital affiliates are in an unusually good position to diversify their portfolios and reduce the risk inherent in venture capital investments. Their portfolios are diversified across such industries as manufacturing, services, communications, health care, technology, and retailing, with no industry accounting for more that a quarter of the total. Their portfolios are also diversified geographically, with investments in nearly every state and the District of Columbia. And bank portfolios include investments in a great number of companies, well over 1,300 currently, insulating them from the risk of concentration of their investment in only a relatively few businesses, which could experience losses that exceed the norm.

While the regulatory restrictions on equity investments by bank groups are significant,[1] there is considerable room for expansion of their participation in the venture capital market. Banks with venture capital subsidiaries currently invest, on average, only one-third of one percent of total bank group assets in this manner. Banks and other venture-capital investing corporations are not different from any other type of potential venture capital investor. They respond positively to increased rates of return on investment. Indeed, publicly-held companies are particularly sensitive to the rate of return earned on investment capital, as their financial statements are carefully scrutinized by shareholders and investment advisors. A reduction in the rate of tax on their capital gains would increase the rate of return on venture capital investments and obviously make these investments more attractive to bank management and bank stockholders.

Tax Policy Concerns

A reduction in the tax on capital gains is appropriate to compensate for the limitation under current law on the deduction for capital losses. Capital losses are currently deductible by corporations only to the extent of capital gains. If a corporation with recognized capital losses does not have any offsetting capital gains within the five-year carryover period, it loses the deduction for the losses entirely. The limitation may thus well result in excessive taxation over time, when gains are eventually recognized that cannot be offset by earlier losses, and it is thus questionable from an economic standpoint. While its administrative purpose in the tax law is understandable, so long as the limitation exists it creates a strong disincentive to making relatively risky investments. A reduction in the tax on capital gains is an appropriate mitigation of the effect of the limitation.

The venture capital investments of corporations are also heavily-taxed under current law. The return on venture capital invested by corporations is effectively taxed at three levels: (1) The earnings of the recipient of the capital are subject to the regular corporate income tax, (2) the gains earned by the investing corporation (in our case the bank's venture capital subsidiary) are subject to the corporate income tax, and finally (3) distributions of those gains to individual stockholders of the investing corporation or its parent (in our case the bank holding company) are once again taxed. This compounding of tax -- an effective direct tax rate of 57.75 percent on venture capital profits that are ultimately distributed to the investing corporation's stockholders -- acts as a significant disincentive to venture capital investments by banks and other

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[1] In general, equity ownership in any one corporation is limited to 4.9 percent of the voting stock and 24.9 percent of total equity. The Small Business Investment Company program excepts banks from these limitations, but only with respect to investments in small corporations.

corporations. As we have seen, however, banks are in a particularly advantageous position economically to provide venture capital to the market. A reduction in the rate of capital gains tax on corporate venture capital investments is certainly appropriate and would remove a disincentive to an otherwise economically desirable investment activity.

* * * * *

In conclusion, the Alliance for Business Investment supports the reduction in tax on capital gains as proposed in the Job Creation and Wage Enhancement Act of 1995. We urge the Committee to bear in mind the contribution made by the investments of banks and other corporations, and in particular the important role they play in providing venture capital to the small and medium-sized growth-oriented companies that are at the heart of innovation, economic expansion, and job creation.

Chairman ARCHER. Thank you, Mr. Chapoton.

And our last witness is Dr. Jane Gravelle, Senior Specialist for Economic Policy with the Congressional Research Service.

Dr. Gravelle, you may proceed.

STATEMENT OF JANE G. GRAVELLE, PH.D., SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Ms. GRAVELLE. Thank you, Mr. Chairman, members of the committee. I thank you for the opportunity to appear before you today to discuss the economic effects of capital gains tax cut proposals. My discussion is focused on proposals in the Contract With America. It addresses the revenue costs and some other issues.

Given our current concern for the size of the budget deficit, an important issue is the potential revenue loss from this capital gains tax cut which is currently estimated at around $60 billion over the next 5 years. If tax cuts increase the budget deficit and are not otherwise paid for, the effect will be to reduce the Nation's savings. The consequences for the budget deficit may be markedly different from those indicated by the current 5-year revenue estimates. There are two reasons I believe that this cost may be larger than suggested by current revenue estimates.

First, the revenue cost of the capital gains tax cut is dependent on the size of the realizations response which may be currently overestimated. Both the administration and the Joint Committee on Taxation include in their revenue estimates the expectation that individuals will respond to lower capital gains taxes by increasing realizations of capital gains. This effect lowers the static estimate in the budget window by more than 60 percent.

There have been extensive criticisms of the methodologies of statistical studies used to measure this response. In recent years, new evidence has been presented that suggests that this response may be smaller than that assumed in the past, especially after the first few years. In a study that I have prepared, the observation of historical ratios of realizations to accruals was used to calculate an upper limit of this response suggesting a much lower realizations response.

This research was recently corroborated by a new statistical study that controlled for certain problems that had occurred in the past. This problem was basically that a lot of these studies were probably picking up transitory responses rather than permanent responses to lower capital gains rates.

If these new lower measures of realizations response were used, the revenue cost would probably double. Second, the revenue loss associated with the proposal would likely be much larger beyond the 5-year budget window in part because of rapid growth of the loss due to indexation. This effect, even using the higher realizations response, could eventually more than double the estimates. Both effects taken together, the lower realizations response and the transition to indexing, could more than triple the revenue costs.

It is also important to note that we cannot necessarily depend on the capital gains tax cut to offset any deficit-induced effects on national savings by stimulating private savings. Economic theory does not assure that cutting taxes on capital income will increase private savings because of offsetting income and substitution effects, and empirical evidence has not clearly supported such a response.

I would like to quickly summarize some other points made in my written testimony. First, that cutting capital gains taxes may improve the efficiency of economy in some ways but may increase other distortions. The overall effects are not clear.

Currently, capital gains taxes are increased above rates on ordinary income due to taxation of inflationary gains but are reduced to defer failure of tax gains and the current tax cap.

In terms of distribution across the income classes, capital gains tax benefits accrue mostly to higher income individuals. For example, previous data presented in 1990 for a 30-percent exclusion indicated that over half of the benefit would go to the top 1 percent of taxpayers and about three-quarters to the top 5 percent.

Finally, while there is no particular complexity in reintroducing an exclusion, inflation indexing is likely to lead to additional complexity as will the prospective nature of the change.

Thank you.

[The prepared statement follows:]

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Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service

Before

The Committee on Ways and Means
United States House of Representatives

January 25, 1995

on

Capital Gains Tax Proposals

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the opportunity to appear before you today to discuss capital gains tax cut proposals. My discussion is focused on the proposals in the House Republican Contract with America, but the analysis, of course, applies as well to similar Congressional proposals.

I would like first to discuss the effects of these proposals on the budget deficit, both in the short term and in the long run. Secondly, I would like to discuss the economic effects of these tax changes on economic efficiency, on both horizontal and vertical tax equity, and on the complexity of the tax system.

Given our current concern for the size of the budget deficit, an important issue is the potential revenue loss from this capital gains tax cut, currently estimated at around $60 billion over the next five years. If tax cuts increase the budget deficit and are not otherwise paid for, the effect will be to reduce the nation's savings. The consequences for the budget deficit may be markedly different from those indicated by the current five year revenue estimates.

There are two reasons to believe that this cost may be larger than suggested by current revenue estimates. First, the revenue cost of the capital gains tax cut is dependent on the size of the realizations response, which may be currently overestimated. Second, the revenue loss associated with the proposal will likely be much larger beyond the 5-year budget window, in part because of the rapid growth of the loss due to prospective indexation.

As you know, there has been considerable disagreement over the past few years over the revenue consequences of a capital gains tax cut. Both the Administration and the Joint Committee on Taxation (JCT) include in their revenue estimates certain behavioral responses. The most important of these responses, by far, is the expectation that individuals will respond to lower capital gains taxes by increasing realizations of capital gains. These increased realizations of capital gains will then produce additional taxable gains and additional revenue which will offset the static revenue loss. (The static revenue loss is the loss arising from the lower tax rate assuming there is no behavioral change.) If estimates used in the past by the Joint Committee on Taxation are retained, this projected increase in realizations will be substantial and will lower the static estimate in the budget window by more than sixty percent.

There has been a substantial body of empirical research on the realizations response, which has yielded a wide range of estimates. In particular, studies that estimated the relationships between realizations and tax rates across different taxpayers (micro-data studies) often yielded extremely large responses. This empirical research is, for a variety of reasons, very difficult to perform, and all of the studies have been subject to a variety of criticisms. In 1990, as you may recall, there was an extensive public debate about the magnitude of these empirical estimates and the merits of the alternative research methodologies employed -- an issue which was never fully resolved.[1]

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[1] These issues were discussed in a variety of different articles at that time. See, for example, Gerald E. Auten, Leonard E. Burman and William C. Randolph, Estimation and Interpretation of Capital Gains Realizations Behavior, National Tax Journal, September 1989,

In recent years, I believe that new evidence has been presented that suggests that this response may be smaller than that assumed in the past, especially after the first few years. First, because of the wide variation in estimates based on statistical analysis, I prepared an alternative method of assessing the likely size of the realizations response.[2] This analysis is based on a relatively simple observation -- in the long run, realizations cannot exceed accruals. That is, realizations would equal accruals over a long period of time (year after year) only if individuals sold all assets after holding them less than a year. Indeed, one would never expect that all gains would be constantly realized, even in the absence of taxes and other transaction costs. The observation of historical ratios of realizations to accruals can be used to measure the upper limit of the realizations response and to suggest a likely size of that response. This analysis suggested a lower, perhaps much lower, permanent realizations response than that measured in most statistical studies. Basically, this type of approach provides a "reality check" on statistical estimates.

This approach suggests that the very large realizations responses found in most microdata studies lead to implausible estimates of changes in realizations responses, and suggests that the results found in these studies probably reflect transitory rather than permanent realizations responses.

A recent statistical study, which used a new approach to control for transitory effects that had long plagued microdata statistical studies, also found much smaller realizations responses, results which are more plausible in light of these historical measures of realizations and accruals.[3] If the findings in these recent studies are correct, the revenue estimates could be twice as large as they would be based on prior year assumptions.[4]

Secondly, the prospective indexing feature of the capital gains tax cut proposal is a provision that costs little in the five year budget horizon because it applies only to newly purchased assets. (Indeed, it is possible that such a provision raises revenue initially, as it induces sales in order to qualify for inflation indexing.) The loss from indexing grows rapidly, however. Prospective indexing allows indexing for inflation only for assets purchased after a given date. After one year, therefore, the reduction in taxable gain would be one year's worth of inflation for assets sold after one year. In the second year, the reduction would be one year's inflation for assets sold after one year, plus two years of inflation for assets sold after two years, and so forth.

On a static basis, this provision might eventually increase the revenue cost as estimated in the budget window by about fifty percent after it takes full effect. If, however, the realizations response used in the past by the Joint Committee on Taxation is assumed to be correct, this provision could more than double the revenue loss because it would apply to a much expanded base. Both of these effects taken together -- a smaller realizations response than that used in the past and the transition to full indexing -- could more than triple the eventual cost of the proposed capital gains tax cuts.[5]

If the cost is much larger than budget projections, either the revision will decrease national savings through a higher budget deficit or require larger offsetting changes elsewhere to maintain budget deficit neutrality.

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pp. 353-374; Can a Capital Gains Tax Pay for Itself? by Jane G. Gravelle, Congressional Research Service Report 90-161, March 23, 1990; Gerald E. Auten and Joseph Cordes, Cutting Capital Gains Taxes, Journal of Economic Perspectives, Winter, 1991, pp. 181-192.

[2] See Limits to Capital Gains Feedback Effects, by Jane G. Gravelle, Congressional Research Service Report 91-250, March 15, 1991.

[3] Burman, Leonard E. and William C. Randolph, Measuring the Permanent Responses to Capital Gains Tax Cuts in Panel Data, American Economic Review, September, 1994, pp. 794-809. More recent surveys of the literature cover this more recent research; see George R. Zodrow, Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity, In Tax Law Review, Vol. 48, No. 3, 1993, pp. 419-527; Jane G. Gravelle, The Economic Effects of Taxing Capital Income, Cambridge, MIT Press, 1994, p. 143-151.

[4] This calculation assumed a coefficient of 3.5 for prior revenue estimating assumptions and a coefficient of 1 for a revised estimate, using a semi-log estimating function and assuming the reduction in tax rates is 45 percent.

[5] This estimate assumes that inflation indexing is roughly equivalent to another fifty percent exclusion. See Jane G. Gravelle, Estimating Long Run Revenue Effects of Tax Law Changes, Eastern Economic Journal, Vol. 19, Fall, 1993 for a discussion of the time path of revenue losses from prospective indexing of capital gains.

It is also important to note that we cannot necessarily depend on the capital gains tax cut to offset deficit-induced effects on national savings by stimulating private savings. Economic theory does not assure that cutting taxes on capital income will increase private savings because of offsetting income and substitution effects. Although an increase in the rate of return will cause some greater preference for future consumption and the savings to accomplish it, an increase in the rate of return will also enable the attainment of a fixed or even higher level of future accumulations with less savings. Or, to make this point another way, if you were saving for a fixed target, an increase in the interest rate would reduce savings.

Because of this theoretical ambiguity, it is necessary to turn to empirical research to determine whether private savings will increase, and empirical evidence would be necessary in any case to determine the magnitude of any effect. While it is very difficult to perform this analysis, this body of research suggests that effects of higher rates of return on savings have small effects on savings behavior and, in some studies, negative effects.[6] That is, it is possible that cutting capital gains taxes will reduce savings.

I would also like to briefly discuss other issues that the committee might wish to consider regarding the proposed exclusion and inflation indexing. These issues include efficiency, equity, and simplicity.

Efficiency Issues

An argument for reducing the capital gains tax made by economists is based on the distortions that the tax produces, including the lock-in effect, and the contribution of capital gains taxation of corporate stock to distortions that disfavor corporate equity investments, and the general effect of reducing the taxation of capital. How significant these distortions are found to be depends, of course, on the magnitude of empirical measures of realizations responses and investment allocation (portfolio responses). The distortion arising from lock-in could be significant as a fraction of revenue. At the same time, the proposed tax reductions could magnify other distortions, such as the choice of dividend payout ratio and distortions of other taxes if they are used to replace the revenue. Notably, the reduction extends to noncorporate investments (primarily sale of real estate) as well. Some economists also are concerned about the possibility of low capital gains tax rates playing a role in tax sheltering and avoidance activities. Unfortunately, the role of lower capital gains taxes in increasing or decreasing economic efficiency remains unclear.

Inflation indexing is probably less likely to reduce the lock-in effect than an exclusion. The lock-in effect is most serious for those assets that have been held a substantial period of time, but these assets will receive a smaller exclusion from indexing than short lived assets. For example, if a corporate stock is appreciating at a three percent annual rate and there is a three percent inflation, indexing for an asset held one year will result in an exclusion of 49 percent of gain, while indexing for an asset held 20 years will result in an exclusion of 36 percent of the gain.[7]

Arguments are also sometimes made that the capital gains tax has an important influence on risk-taking, entrepreneurship, and the availability of venture capital, and hence productivity growth. While such a relationship may exist, there is little empirical evidence of a link between the capital gains tax rate and productivity growth. Also, much of formal venture capital offerings is not subject to capital gains taxation,[8] and the vast majority of capital gains accrue on real estate or sales of stock of long established corporations. As you know, a current tax benefit already exists for gains on new stock issues of small business corporations.

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[6] For a summary of this literature, see Jane G, Gravelle, The Economic Effects of Taxing Capital Income, Cambridge, Mass., MIT Press, 1994, p. 27.

[7] The value of an asset costing one dollar held for one year is 1.03 times 1.03 and the gain without indexing would be that amount, minus 1, or .0609. If the asset is indexed, the gains will be 1.0609 minus 1.03 (the latter number the basis increased by inflation), or .0309. The gain is reduced by 49 percent. For the asset held for twenty years, the gain is 1.03^{20} times 1.03^{20}, minus 1; the gain with indexing subtracts 1.03^{20} and the result is an exclusion of 36 percent.

[8] See James Poterba, Venture Capital and Capital Gains Taxation, in Tax Policy and the Economy, vol. 3, ed. Lawrence Summers, National Bureau of Economic Research, MIT Press, Cambridge, 1989.

Finally, there is no correct way to provide for an inflation adjustment for capital gain on the sale of depreciable property, when tax depreciation itself is not reflective of economic depreciation.

Equity Issues

An important argument for indexing capital gains is that gains include those arising solely from general price changes in the economy. These gains do not constitute real income and it may be argued that it is unfair to tax them. At the same time, capital gains income benefits from other aspects of the tax law, including the ability to defer taxation of income and the ability of avoid taxation entirely on assets held until death. Higher income individuals also benefit from the current 28 percent cap. In addition, the taxpayer has the advantage of control over the realization of gain, so that he can choose to realize offsetting losses.

Whether, on average, these benefits outweigh the penalties imposed by taxing inflationary gains depends on average holding periods and inflation rates. Currently, it is likely that the average effective tax rate on capital gains is lower than the statutory rate for corporate stock where such effective tax rates can be calculated. This effect varies across individuals and assets, depending on the holding period and the real appreciation rate. The combination of the fifty percent exclusion and inflation indexing will lead to effective tax rates well below the statutory rate.

Vertical distribution effects of the capital gains tax cut may also be of interest to the Committee. A capital gains tax cut will primarily benefit higher income individuals. When a thirty percent tax cut was proposed in 1990, the Treasury department estimated that 54 percent of the benefit would have gone to those with incomes over $200,000, a group constituting about one percent of the population.[9] About 74 percent would have gone to the top five percent earning over $100,000.

Simplicity

While, the addition of more tax preferences for capital gains is likely to induce greater efforts to convert ordinary income into capital gains, there is no inherent complication in actually computing capital gains with an exclusion. The proposal from prospective inflation indexing would, however, be more complicated. Unlike an exclusion, an inflation adjustment requires a separate adjustment for each vintage of assets. Also, since only assets purchased after a given effective date would be eligible for indexation, further complications would occur, since eligible assets would have to be purchased after a given date.

[9] Classification was based on five year averages in order to mitigate the problem that individuals would appear in the higher group because of realization of a large gain in one year.

Chairman ARCHER. Thank you, Dr. Gravelle. You have opened the door for some interesting colloquy.

When you say capital gains are not taxed at death, is it not true that the capital gains included in the market value of every asset are taxed at the highest percentage rate of any tax in our system, 55 percent?

Ms. GRAVELLE. You are talking about estate tax?

Chairman ARCHER. Yes. Is it not true that the market value of the assets receive a 55 percent tax, including the capital gains, the appreciation during a lifetime?

Ms. GRAVELLE. That is right.

Chairman ARCHER. They are taxed in a big way at the time of death?

Ms. GRAVELLE. That is correct. Although there are a lot of exclusions, a lot of exclusions from the estate.

Chairman ARCHER. But when you talk about what I personally disagree with as to the distribution tables about who gets the benefit from capital gains, if in fact it is the top 1 percent, as you say, then they are the ones who are going to pay the estate taxes, big time.

Ms. GRAVELLE. Well, if they have Mr. Chapoton for a lawyer——

Chairman ARCHER. But in order to involve more of our panel in this discussion, Mr. Chapoton, do you have any disagreement with the analysis that Dr. Gravelle has just presented to the committee?

Mr. CHAPOTON. Well, I do have several points of disagreement. I think that she would agree that lowering the capital gains rate is positive for savings and investment and her fundamental point is that, in the process, you increase the deficit by a greater amount than you will offset it with the positive effect of a capital gains cut, and I think it is a valid point.

You know it, this committee understands it, that you do need to cut spending when you do this. The other, of course, question that she also raises is how much the capital gains cut will reduce revenues if at all. And that is a many, many factored question which has been discussed at length before this committee.

But I think that is really the significant question here. I think everybody would agree that lowering capital gains rates is positive for the economy and positive for savings and investment.

Chairman ARCHER. In the current environment you have the President, Newt Gingrich, Al Gore, and a majority of both the Senate and House of Representatives committed toward getting to a balanced budget. Irrespective of how they say it, they want to get there. It seems to me that the argument that if you don't tax capital gains that you are increasing the deficit, and therefore you are offsetting one type of savings with another, is not valid. It merely means that another area of consumption will be squeezed in order to get to that balanced budget.

So it seems to me, in the current environment, that is not a valid empirical argument. But let me test out something on all five of you because I have tried to approach things from a basic common sense standpoint. What are the sources of capital?

We all know we have to have capital to increase productivity in order to increase real earnings or standards of living. I think everybody would agree with that. You have to have savings that are invested if you want to increase productivity. Now, where can that capital come from? Where do those savings come from?

Well, government can tax the production of people and instead of spending it on consumption-type items, which we do in this country today with the proceeds from our taxes, the government can build the factories, buy the tools, and provide the jobs. That is one source of capital. You are all nodding. That has been tried in the Soviet Union. It has been tried in Western Europe and they have all moved away from it because it doesn't work. So let's put that one off the table for the United States of America.

The second source of capital will depend on the savings of foreigners who have a higher savings rate and who are permitted to keep their savings when they have a capital transaction instead of having it taken away from them by government. Those foreigners then can come in and they can build the factories, and they can buy the tools, and they can provide the jobs so that we can increase our productivity.

Most Americans that I talk to don't much like that, but we have become dependent on more and more of that as a source of providing the tools of production in this country.

The disadvantage, besides that Americans don't like it, is that we then have a mortgage on our productivity for all time for dividends and interest that have to be taken overseas.

The third way of savings and capital investment is that Americans have to forgo consumption, and they have to provide the savings to increase productivity. And I am a firm believer that we have got to stop talking about the rich against the poor or the corporations against the individual. We must protect savings wherever we find them because savings are what we lack in this country.

If, in fact, higher income people are where the greatest savings are, then we should gladly be prepared to protect and encourage that because every worker's personal standard of living, family real earned income, can increase by our productivity. To me this is very, very basic.

Is there any one of you that disagrees with that?

Ms. GRAVELLE. I just would like to remind you that at least the point that I made in my testimony is that we can't be certain that cutting these taxes will increase savings—private savings. We can't be certain of that. Our theory tells us that we don't know for sure, and if we look at the evidence on this issue we don't find the evidence.

Chairman ARCHER. You are leading me to my next basic point. It seems to me that the nucleus of existing domestic savings in the United States is just as important as new savings that we can attract. Every one of those dollars of savings is available to be employed to increase productivity.

And I don't think you need to be in an ivory tower with a theory to understand that whenever you sell a business that has 10 machines and the government takes 2 of those machines and sells them and puts the money in the Treasury to be spent on consumption, that you have got less capital employed in the domestic marketplace. And that is precisely what happens with a capital gains tax. Every time you have a transaction, a part of capital savings that is already out there is vacuumed up by the giant vacuum cleaner, brought into the Treasury and disbursed on consumption items for the most part.

Obviously, building roads and infrastructure is not a consumption item. Do you disagree with that? You can talk about theory but isn't that the practical reality of what exists?

Ms. GRAVELLE. Basically, what I am trying to say is that when we try to look for evidence on whether changing tax rates or changing the rates of return—any of these things that change the return to investors—we do not find that clear evidence that aggregate savings goes up. In the case where somebody is selling machines, the machines are still there. It depends on what people do with all of their savings when they are faced with a tax.

Chairman ARCHER. You are going back to half the equation which is incentive for new savings. I am also talking about existing capital savings.

Ms. GRAVELLE. Existing capital can't be destroyed. Physical capital is still there.

Chairman ARCHER. It is. If every time you have a transaction the government takes 20 percent of that, 28 percent if you have a zero basis, there is 20 to 28 percent less in the marketplace than there was before, and that is converted to consumption.

Ms. GRAVELLE. The point is that it is not clear that that is what happens.

Chairman ARCHER. But it has to be. You are talking about whether there is an incentive for new capital. And you can theorize on that. These gentlemen would disagree with you. But relative to existing capital it can't be a theory. It has to be a reality. You are converting capital savings to consumption. There is no way it could be otherwise.

I am wondering if you gentlemen would agree that the existing nucleus of capital savings can be just as important as new savings. And let me predicate that by saying, since you are venture capitalists, many of you, that someone has to save to put the venture capital in there. Cannot venture capital just as easily come out of the existing savings pool as well as from potentially some incentive for new savings?

Mr. PIEDRA. Mr. Chairman, if I may, I would like to address two of the issues.

One is the one you just mentioned, which indeed it is. If we can free up locked-in capital and move it to job creating capital investments, it would be a tremendous boon to the economy, no doubt about it.

But we are also ignoring a hard fact as to the results of capital gains tax reductions. And that is hard historical data, not future analysis, not theoretical analysis, but historical data indicates that every time we cut capital gains, tax investments go up and so do collections on realized capital gains. I think we are ignoring that hard fact, not hypotheses.

Chairman ARCHER. Let me say maybe some of the theoreticians are ignoring it. I am not.

Mr. BRODY. I am not an economist. I just go based on what I see in real life.

I describe an example of a company where the founders, the new management, the entrepreneurs as a group, made in excess of $100 million. They come to me, and they say we don't want to pay capital gains. If we sell our shares we don't participate in the upside of the company, and there is a big toll tax when we go home.

Many of these people are now experienced and very successful entrepreneurs, and if their capital was unlocked not only would you get their capital going to other situations, you would get their experience and talents helping other people, which would have a multiplier effect.

I agree if there were a reduction in the capital gains rate it would liberate capital and the productivity and multiplier effect. You would have a big impact stimulating productivity and new jobs going forward.

Mr. MORGAN. Mr. Chairman, again living through these things perhaps makes a bigger impact on you than looking at the numbers.

I have lived through the ups and downs of the capital gains rate in this country. When I started my company, my own firm in 1981, a third of the capital came from families, repositories of wealth, usually industrially successful families who were willing to take the risks, the illiquidity, and, frankly, a little bit of the vicarious enjoyment of participating in creating new ventures and taking the risks that are associated.

Come 1986, that source of capital just about dried up because these families may or may not have had good investment advisors, but they all had good tax advisors, and the tax advisors quickly pointed out to them that risk and illiquidity, along with a tax on the winnings, just didn't compute to being a sensible investment.

That also affects the angel investors, people that make a little bit of money. And in the Boston area they are called the breakfast club, and these successful entrepreneurs get around in the morning at breakfast and decide whether or not they are going to give a little bit of money to somebody else to start a company. But they do pay attention to the tax rates, and if the tax rates permit them to keep a good hunk of their winnings they will take those kinds of risks.

Chairman ARCHER. Thank you very much for that input. You are real people out there realizing the decisions that people make in a real world, and we are very grateful to have your input.

Mr. Collins will inquire.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Chairman, I like your example of the vacuum cleaner. Ms. Gravelle, do you have a vacuum cleaner?

Ms. GRAVELLE. I sure do.

Mr. COLLINS. What happens when you turn it on?

Ms. GRAVELLE. Hopefully, it sucks up the dirt from my rug.

Mr. COLLINS. It also makes a loud noise. I despise the one that my wife has. But that sucking is heard by a lot of people who own assets that they would probably sell or would like to sell, but they feel locked in because they hear that noise.

A couple of years ago I was in a small TV rental shop in Georgia. The area was not much bigger than this area here—not this room. When I walked in, the lady immediately, knowing who I am, spoke to me about taxes. She said, you know, I have a small piece of property at the edge of town that I could have sold three times, but

I won't sell it because I don't want to turn over so much of my gain on it to the government. That was that sucking sound that she could hear.

How long have you been with Congressional Research?

Ms. GRAVELLE. Twenty-five years.

Mr. COLLINS. What did you do prior to that?

Ms. GRAVELLE. That is my only job except for going to Treasury and teaching and other things.

Mr. COLLINS. That was pretty evident by your comments.

Mr. Brody, you mentioned the alternative minimum tax. I would like you to go a little deeper with that because the alternative minimum tax is a thorn in my side, too.

Mr. BRODY. There are two potential issues as it relates to the capital gains rate that might ultimately deliver it and the stimulative impact it would have on venture capital.

At one time, when we had an exclusion against capital gains, the exclusion was a preference item for alternative minimum tax, which basically meant you got the exclusion from your capital gain which reduced the amount of capital gain you had. But then you took that exclusion you got and you put it back into your tax return and paid taxes on that as well.

Effectively, when you were done you did not achieve the capital gains rate that was originally advertised. And if you had a full exclusion, which is a full preference—AMT is 28 percent and capital gains rates are 28 percent today at the top bracket—you basically made zero change in reduction.

From the point of view of a venture capital firm, our business is very expense-intensive. We have 110 employees in our firm, over half of whom are professionals. We invest in 10 new companies a year and spend a great deal of time working with those companies, helping them achieve their objectives. Those expenses are not deductible if you are in the AMT. And the result is the expenses we incur to create the capital gains—just as a manufacturer creates expenses to incur revenue—are not deductible.

So if there is an advertised capital gains rate, if we look at what our capital gains is net of the cost to generate those gains, depending on what our expense level is to the level of capital gains in a given year, we can end up with an effective tax rate on capital gains that can be even more than the 39.9 percent that we have in current law.

So that if the objective of the committee and the intent of reduction of capital gains is to stimulate venture capital, as Jim Morgan said, our industry has treaded water since 1987. The amount of new capital coming into our industry has been stagnant. During that same period the mutual fund industry has multiplied four times.

If you want to stimulate venture capital, if you want to create more venture capital firms that can be receptacles for all forms of capital, tax exempt and otherwise, the signal that ought to be given to the industry is that whatever capital gains rate comes out of this committee as advertised and is ultimately approved is the rate that, in fact, we pay when we are done filing our taxes.

Mr. COLLINS. Thank you. I would like to see a repeal of alternative minimum tax altogether.

Chairman ARCHER. Gentlemen—and lady, I forgot to ask each of you what your preferred holding period would be assuming you are not going to have different holding periods with different rates. I don't want to get into that issue. If we have one holding period should that holding period be 1 year, 2 years, 3 years, 4 years or 5 years?

Mr. MORGAN. I understand you want a number, but it is a political judgment. The ideal would be that as we take our companies from illiquid, long-term investments, which is what a venture capital investment is, we are migrating them into the public markets where there is liquidity and where a holding period would interfere with the smooth functioning of that market. But that is the progression of our train, if you will.

So the deal would be that at each step along that train there would be the most efficient capital market and that would imply no holding period for the purpose of calculating capital gains treatment.

In the absence of anything else I guess 1 year is probably as good as any.

Mr. BRODY. I agree.

There was a comment made by a witness that one of the disadvantages of our system is pressure on public companies for quarterly earnings per share performance. I think it impacts their ability to make long-term judgments. I think if you had a holding period of 1 year you would discourage people who are trading and churning in stocks and encouraging people to at least take a longer term view in the companies they invest in, and that would have a salutary impact.

Chairman ARCHER. So you think the 1 year that is in our proposal is the best holding period?

Mr. BRODY. I think it would be sufficient.

Mr. PIEDRA. One year, Mr. Chairman. From the employee side, these stock options that employees hold in the companies are usually over 4 or 5 years, so they have been working hard for that period of time and the shorter the holding period the better.

Mr. CHAPOTON. I agree. I think 1 year. It was 6 months for many years. There has been talk about a longer holding period. I think with the latter you get closer to what we refer to as targeting, and I think you ought to stay away from that.

Ms. GRAVELLE. I can't recommend a particular year. If you have a holding period that is too long and you have a differential, you create sort of a mini-lock-in problem that you need to think about. I don't have any specific——

Chairman ARCHER. One year you think is adequate to take care of the trading in derivatives and a lot of churning-type activities which many people say don't really increase capital investment?

Mr. BRODY. I think there is a tradeoff. One year will have a significant impact. Obviously, 5 will have a greater impact. But there are disadvantages if you go out further than 1 year in terms of investment behavior.

Chairman ARCHER. Thank you.

Mr. English will inquire.

Mr. ENGLISH. Dr. Gravelle, welcome. I note in your testimony that you indicate that the evidence is ambiguous on the dynamic effects of capital gains tax. And perhaps that is because the methodologies would have difficulty dealing with many of the other factors that might be in place. Is that fair to say?

Ms. GRAVELLE. There are two kinds of effects. You are thinking about the realizations response?

Mr. ENGLISH. Yes.

Ms. GRAVELLE. All studies done of the realizations response—they had a lot of problems, and that is really—and they produced very wide variations and estimates.

Mr. ENGLISH. So, really, the jury is not in on the dynamic effects from the standpoint of academic research of a capital gains tax. Is that fair to say?

Ms. GRAVELLE. I don't think anybody could pinpoint the number. The research that I did simply showed that you don't have that much room to expand realizations. You can never realize more than you accrue. So if you look over history and you have already realized a lot of what you accrue that only leaves so much room and that room is not big enough to accommodate some of the investments already done.

And we are going to see this—if we estimate big capital gains reductions, your realizations will be so large with some estimates it would be implausible.

Mr. ENGLISH. But there are economists that would come at it from a different angle and might suggest there would be more dynamic effects?

Ms. GRAVELLE. There is certainly room for disagreement, yes.

Mr. ENGLISH. I want to focus the balance of my questions on the equity side.

First of all, is it not fair to say that, just from a factual standpoint of tax returns claiming a capital gain, that nearly 50 percent of those returns are filed by taxpayers with less than $40,000 of adjusted gross income?

Ms. GRAVELLE. I don't know those numbers, but I wouldn't find that surprising.

Mr. ENGLISH. Of tax returns claiming a capital gain, nearly 60 percent of those returns are filed by taxpayers with less than $50,000 of adjusted gross income. My source on that is the Statistics of Income bulletin, fall of 1994. It is a good source.

So I would take from that that just from a pure equity standpoint the beneficiaries of capital gains are certainly not confined to the upper-income bracket?

Ms. GRAVELLE. It depends if you want to look at the number of beneficiaries or how many dollars they get.

Mr. ENGLISH. Frankly, I think probably the distribution of benefits is a more useful approach. Many of the so-called rich who would benefit from a capital gains cut are in a king-for-a-day category. In other words, they have liquidated assets in a particular year so they show up on the tables as being an upper-income taxpayer for 1 year; but as a practical matter, looking at their history of income, they are not rich. They are middle class. Is that fair to say?

Ms. GRAVELLE. Most of the data that I cited used a 5-year average to try to deal with that problem. Those studies found that, in most cases, the people realizing gains and in those high-income categories were there most of the time. That is a phenomenon, but it is not a dominant one.

Mr. ENGLISH. You don't think that makes up a large portion of the capital gains?

Ms. GRAVELLE. No.

Mr. ENGLISH. That is interesting.

I have no further questions. Thank you, Mr. Chairman.

Mr. ZIMMER [presiding]. Mr. Christensen.

Mr. CHRISTENSEN. I just have a brief question.

For 2½ weeks now we have heard testimony from everybody from academia to bureaucrats to real, live people that are out there in the world fighting with the government each day. Why is it that lifetime government employees and lifetime professors, who have never ever been out in the real world, almost unanimously oppose a capital gains tax reduction.

Dr. Gravelle, please explain to me what it is that we are missing.

Ms. GRAVELLE. First, I would like to make my position straight. I am not here to say I oppose the capital gains tax cut, but I am here to say that it is going to cost a lot of money I think to make these tax changes. And if you are concerned about savings and investment you are going to have to be concerned about that revenue.

I think the efficiency issues for capital gains tax cuts are mixed. Some kinds might be better than others. A lot of this capital gains cut will go to real estate. Maybe the ones that go to corporate stock would be more efficient.

I have written a lot about this that I couldn't put in my testimony.

Mr. CHRISTENSEN. I appreciate that. If you weren't working for the taxpayers at the Congressional Research Service and say you were on the other side of the fence in the private sector, do you think you might have a different opinion?

Ms. GRAVELLE. I can only tell you as an economist, and I think my opinion as an economist is, hopefully, totally unaffected by my personal situation and would be then, hopefully, too.

Mr. ENGLISH. Let me comment that I am a lifetime policy analyst and government employee that supports cutting the capital gains tax. Thank you.

Mr. CHRISTENSEN. That is refreshing.

Mr. ZIMMER. Thank you very much, members of the panel. We appreciate your joining us.

Will panel number three please come forward?

I thank our third panel for joining us.

We will first hear from Robert DeHaven, who is the president and chief executive officer of Quality Systems, Inc., on behalf of the American Electronics Association.

STATEMENT OF ROBERT C. DEHAVEN, FOUNDER AND CHIEF EXECUTIVE OFFICER, QUALITY SYSTEMS INC., FAIRFAX, VA., ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION

Mr. DEHAVEN. Thank you, Mr. Chairman. You have my testimony.

I grew up on a farm in Pennsylvania, and I am sorry that Mr. Stark isn't here. I wanted to point out that I first became an entrepreneur at the age of 9. I received 5 cents for each cow that I milked. And I was fortunate enough. I went to college on an athletic scholarship and at 35 mortgaged everything that I had to start a company.

I am founder and CEO of Quality Systems Inc. We employ 400 scientists and engineers in Northern Virginia. Today, we are a subsidiary of Tracor, a good Texas company. I have firsthand experience with the impact of capital gains tax on small private businessowners.

I am also chairman of the board of the American Electronics Association, the largest high-tech trade association in the world. We represent over 2.3 million workers, and we have 300 corporate members ranging from Microsoft, Intel, to AT&T, to small, rapidly growing firms. Seventy percent of our companies employ fewer than 200 people.

I believe we have empirical evidence that suggests that reducing the capital gains tax creates jobs, promotes high risk, high return investment, increases competitiveness; and it is fair. I would like to touch on each briefly.

Creates jobs. Starting a new company, cash is king. The cost of capital is the most important cost. New ventures not pursued are generally abandoned because of cost of capital. Successful new ventures create jobs. How many will H.R. 9 create? I don't know.

After 1978 and 1981 cuts, we enjoyed 1 million new U.S. electronics jobs between 1978 and 1984. We witnessed numerous successful startups. In fact, 15 years ago 65 percent of our 3,000 members did not even exist. Now we have Sun, Microsoft and Compaq. A direct result of a reduction in the capital gains tax? No, but it was helpful. A reduction in the capital gains rate helps create high-tech, high-paying jobs.

Competitiveness. It is a global economy. Even the smallest U.S. companies compete with Japanese and European firms. Cost of capital is the most important cost of doing business in a growing firm. If that cost is significantly higher than in the United States, our companies are at a disadvantage.

Our competitors understand this. That is why in Japan the rate is 20 percent, France 16 percent, Germany zero, Austria zero, Hong Kong zero, Singapore zero and in Belgium zero. A reduction in the capital gains tax rate increases the competitiveness of U.S. technological and financial firms in the global market.

Three, a reduction in capital gains promotes high risk, high return investment. As you all know, high technology products improve the quality of life for American citizens. It also saves American lives. Developing these technologies is expensive, and it is risky. Taxes, including capital gains taxes, are simply a cost of doing business. If the tax rate goes down the cost of investing in new technology goes down; and, therefore, more money becomes available for projects.

I hope this doesn't make me one of those terrible trickle-down terrorists that I have been reading about, but it is John Maynard Keynes who said the engine who drives enterprise is not thrift but profit.

This thought brings me to my final point: Capital gains is fair. The responsible literature suggests that H.R. 9 will have a minor impact on the Treasury. Some say, as we heard this morning, it will be negative. Some say it will be positive. It depends upon how you ask the question and what answer you want.

H.R. 9 has been attacked as unfair because most investment capital comes from so-called wealthy taxpayers and that they will benefit. Some feel this is inherently bad.

I know the 70 percent of AEA's members who are building private companies that employ fewer than 200 people—I was one—they are not wealthy, but they will benefit. I know the employees of the 84 percent of our high-tech growth companies who own stock or have stock options—I was one—they are not wealthy, but they will benefit. And I know the many small investors that have their money broadly invested in funds for their retirement—I was one—they are not wealthy, but they will benefit.

Mr. Chairman, when I consider the benefit to these people, the jobs H.R. 9 will create, the technologies it will help develop and how it will make U.S. companies more competitive, I think it is fair. On the other hand, is it fair to tax these businessowners, these employees and these investors on the inflated values of their holdings? I don't think so.

If you invested $10,000 in 1973 at a rate of 7.4 percent for 20 years it becomes worth $42,000. That is a $32,000 capital gain. At 28 percent, you would owe a tax bill of $9,000. But if you adjust that $32,000 for inflation over that time it is worth $9,500. After you pay your tax bill you are left with $500 on your 20-year investment. That is not fair. How can a middle-class worker retire on that kind of return?

Furthermore, is it fair to tax the shareholder of a business twice? For every $100 a business makes, it pays $35 in income tax. The remaining $35 is put back into the company. It increases the value of the stock of the company and, therefore, is considered a capital gain and is taxed at 28 percent, for a total tax rate of 53.2 percent. Is that fair? I don't think so.

It seems to me that rather than agonizing over how to redistribute the wealth pie among Americans we should seize the opportunity to make it bigger. H.R. 9 is such an opportunity. It creates jobs; it increases investment; it increases competitiveness; and, Mr. Chairman, it is fair.

Mr. Chairman, AEA endorses the capital gains provisions of the Job Creation and Wage Enhancement Act. Thank you.

[The prepared statement follows:]

Statement of
Robert C. DeHaven
Chief Executive Officer, Quality Systems Inc.
Chairman, American Electronics Association

Good afternoon, Mr. Chairman, and members of the Committee. My name is Robert C. DeHaven and I am the founder and Chief Executive Officer of Quality Systems Incorporated -- a company based in Fairfax, Virginia -- employing over 400 scientists and engineers. I am also Chairman of the Board of the American Electronics Association (AEA) -- an organization that represents some 3,000 U.S. technology companies based in 44 states. These companies, which range from small start-ups to the Fortune 500, span the breadth of the electronics industry, from silicon to software, to all levels of computers, communications networks, and systems integration. More than 70 percent of AEA members employ less than 200 people.

I am pleased to be here this morning to present AEA's views on H.R. 9, The Job Creation and Wage Enhancement Act, with specific reference to the provisions relating to capital gains. Mr. Chairman, the AEA first testified before this committee on capital gains in 1978. As you may recall, those hearings led to the enactment of the Steiger Capital Gains Amendment and, in our opinion, set the stage for the explosion of the electronics and computer industry during the 1980's.

The U.S. economy is growing -- not by leaps and bounds -- but nonetheless growing. Long-term interest rates are still -- historically speaking -- comparatively low and inflation appears to be under control. Worker productivity has steadily increased and corporate America has become less bloated, more competitive. These are the building blocks for enhanced competitiveness and economic growth, yet millions of Americans still feel insecure about their economic future. Many of the high wage, high skill jobs that were eliminated during the 1991 recession are simply not coming back.

So what should we do to get these Americans back to work? What should we do to increase global competitiveness? AEA believes one important step is to work towards a "growth friendly" and "investment friendly" tax code. And that is why we enthusiastically support the capital gains provisions contained in H.R. 9.

As this Committee moves forward with these hearings and as H.R. 9 moves through the Congress, I want to stress that unlike most other legislative proposals, there is solid empirical evidence to support our conclusions regarding capital gains. Simply stated, a capital gains tax reduction will 1) create jobs; 2) promote high risk, high return investment; and 3) increase competitiveness. In addition, and perhaps most important, the evidence confirms that a capital gains tax cut is fair.

1) CAPITAL GAINS CREATES JOBS

Mr. Chairman, economists generally agree that the tremendous entrepreneurial growth of the electronics industry during the 1980's was due, at least in part, to the 1978 and 1981 cuts in the capital gains tax rate. This boom of investment produced such start-ups, turned giants, as Sun Microsystems, Microsoft, Compaq Computer, and Conner Peripherals. These four companies have produced billions of dollars in exports and created thousand and thousands of new jobs. The explosive growth of new investments helped fuel the creation of over one million new jobs in electronics between 1978 and 1984[1]. Another indication of the electronics industry's growth is reflected in the fact that 15 years ago 65 percent of AEA's 3,000 member companies did not exist.

While the circumstances of each company's formation were and are different, those of us who have "been there" and "are there" starting and running companies know that many firms might not exist today had Congressman Steiger and others not acted in 1978. Likewise, we know that the 1986 Tax Reform Act, which increased the tax rate on capital gains income from 20 percent to 28 percent – a 40 percent tax hike -- has discouraged

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[1] Source: American Electronics Association

entrepreneurship and caused many investors to hold on to assets they would otherwise prefer to sell.

Once again, the U.S. needs to provide incentives to encourage low-cost capital and seed capital held over the long term. As you know, Mr. Chairman, capital gains is in some ways a voluntary tax. Like it or not, annual income taxes are due every April 15th. Capital gains taxes are due only when an individual decides to sell an asset. And since selling is taxed and possessing is not (the tax is deferred), high rates tend to limit the availability of investment dollars and low rates tend to move investment dollars into the most productive parts of the economy. It is not possible to create the kind of investment necessary to create jobs without allowing the free flow of investment capital. A reduction in the capital gains tax rate helps create high technology, high paying jobs.

2) CAPITAL GAINS WILL INCREASE COMPETITIVENESS

We must also understand – as do our major trading partners -- that lower capital gains taxes lead to increased competitiveness. For mid-sized and larger companies, we compete in a truly global financial marketplace where investment dollars are no longer constrained by national borders. For smaller companies and start-ups, that do not yet have the access to the international marketplace, those companies are constrained by the high cost of domestic equity capital. In either case, because the capital gains tax is an important component of the cost of capital, the rate at which countries tax capital can be an important competitive advantage. Certainly international investment decisions are driven by more than relative tax burdens, but global investment dollars will flow to countries where the aggregate return on investment is greatest.

Virtually all of our major trading partners understand this concept and most of our competitors provide much lower tax rates on capital gains or do not tax capital gains at all. We saw this disadvantage first hand during the 1980's when the cost of capital was at least twice as high in the U.S. as it was in Japan. As a result, many U.S. technology companies obtained investment capital in Japan and, in return, traded critical technology. Currently, the long term capital gains tax rates in Japan and France are 20 percent and 16 percent, respectively. Countries like the Netherlands, Germany, Argentina, Austria, Egypt, and Singapore don't tax long term capital gains at all. A reduction in the capital gains tax rate increases the competitiveness of U.S. technological and financial firms in the global marketplace.

3) CAPITAL GAINS PROMOTES HIGH-RISK / HIGH-RETURN INVESTMENT

The third point I want to make is that there is a high payoff to society, and a clear improvement in the quality of life, from investment in high risk products. Examples might include the development of capital intensive medical devices, which clearly provide significant, long-term returns to society. Or high-speed computing, which helps to give the U.S. the edge in global information markets. Or software development, which has education benefit far in excess of any initial tax expenditure.

While some people may believe that it is inherently wrong for certain individuals to make more money, this country was based on the premise that the return on an investment should be commensurate with the risk. It was Keynes who said "the engine which drives enterprise is not thrift, but profit." And, if we truly want to "push the envelope" on high-risk investments, we must understand that the large majority of high-risk investments have value only because of the prospects of producing future income.

If successful, these investments -- a new computer chip or bio-tech drug -- will pay huge dividends throughout the economy, save lives, increase our quality of life, and -- yes -- will provide a reward to the investors who placed their capital at risk. We will see more jobs, greater productivity, and a broader tax base. But if unsuccessful the risk takers will get nothing, and run the risk of losing everything. If we want to move money into high-risk investments, we must understand that the risk / reward ratio operates on the margins -- the lower we can push the cost of capital, and the higher we can get the potential rate of return, the better we will do in promoting high-risk, high return investments. A reduction in the capital gains tax rate encourages investors to support risk, high return investments.

4) CAPITAL GAINS IS FAIR

Mr. Chairman, finally I want to emphasize that a capital gains tax cut is fair. As the issue of a capital gains tax cut is debated, few people will challenge the fact that the capital gains tax reductions of 1978 and 1981 "worked" to create new jobs and new companies. Rather, opponents will focus on the peripheral issue of fairness and will argue that the rich will receive a windfall. These same people feel that increasing the financial returns to the wealthy is inherently bad. Presumably they believe that the benefits to the rich will come at the expense of the poor. But the point of reducing the capital gains rate is to invest in our country's long-term economic health for all Americans.

The fact is that the benefits realized as a result of lower capital gains taxes will be reinvested in the American Economy, not in the pocketbooks of the rich. When we reduce the capital gains tax rate we are providing the investment capital necessary for a long-term economic expansion. We are providing jobs for all Americans. We are creating technologies which provide secondary and tertiary societal benefits, far in excess of the cost of a tax deduction. And, we are laying the foundation for the industries of tomorrow.

I would also add that from the perspective of the high technology community, a capital gains tax cut is a middle class tax cut. That is because of the broad based use of employee stock options. Fifty four percent of high growth companies offer stock options -- a piece of America's future -- to every single employee. And the practice is even more widespread among smaller high-growth companies. A recent survey of our members showed that eighty-four percent of companies with fewer than one hundred employees offered stock options to every single employee. This is equity we are talking about. Equity for hundreds of thousands of middle class, mid-level employees. Equity which some day will be recognized as capital gains. For these employees, a capital gains tax cut is a middle class tax cut.

CONCLUSION

Mr. Chairman, do we want a tax system that imposes high rates on capital gains, significantly reducing the attractiveness of high-risk / high return investments, and resulting in fewer new jobs, fewer new technologies, and fewer new innovations? Or do we want a tax system with low capital gains rates that encourages investment in emerging high technology and other high-risk ventures that offer great societal and economic returns? From the perspective of high technology companies the choice is clear. Low capital gains taxes encourage risk and capital formation. High capital gains taxes discourage risk and capital formation. It's that simple. Capital formation equals high paying jobs. In order to increase the standard of living for all Americans we should focus on how to make the pie bigger rather than agonizing over how to redistribute the size of the pie we have today.

So, as we go forward with this debate I want to stress that capital gains is about jobs; capital gains increases high-risk investment; capital gains increases competitiveness; and, perhaps most important, capital gains is fair. AEA enthusiastically endorses the capital gains provisions of the Job Creation and Wage Enhancement Act.

I would be pleased to respond to your questions.

Mr. ZIMMER. Thank you.

I would like to remind the witnesses that when the red light goes on your time is up.

Our next witness is David Lietzke, vice president, human resources, Bay Networks Inc., on behalf of the Coalition for American Equity Expansion.

STATEMENT OF DAVID LIETZKE, VICE PRESIDENT, HUMAN RESOURCES, BAY NETWORKS INC., SANTA CLARA, CALIF., ON BEHALF OF THE COALITION FOR AMERICAN EQUITY EXPANSION

Mr. LIETZKE. Mr. Chairman and members of the committee, I am David Lietzke, vice president of human resources for Bay Networks in Santa Clara, Calif.

Bay Networks is a new company reflecting the merger of Synoptics Communications and Wellfleet Communications. Our combined company employs over 3,000 employees and generates over $1 billion in revenue. We design and manufacture computer networking equipment.

Like most fast-growing technology companies, Bay Networks has to compete aggressively for the most talented and productive people at all levels. Therefore, we offer our employees an opportunity to share in the company's success. At present, over 90 percent of our employees receive stock options; and 74 percent of them opt to purchase stock through our employee stock purchase plan.

I appear before you on behalf of the Coalition for American Equity Expansion. CAEE is a group of growth-oriented companies and professional organizations dedicated to the promotion of equity compensation in the American economy. CAEE was a leader in the recent battle to prevent the Financial Accounting Standards Board from destroying broad-based employee equity plans.

Mr. Chairman, I am not here to talk about the impact a capital gains tax might have on my company's tax returns. I am here because of the terrific benefit a capital gains tax cut would give to my employees.

I want to say that the old charge that a capital gains tax cut helps only the wealthy is simply wrong. The capital gains provisions of H.R. 9 will give a significant tax cut to many millions of middle-income American households. I will give you two reasons why this is so.

First, H.R. 9 offers a capital gains tax break for every taxpayer at every income level. It is a much more fair and much more populist approach than current law, which limits capital gains benefits to people in the top two tax brackets.

The second reason this bill is a significant tax cut for middle-income Americans is that there are a lot more people in the 15 and 28 percent tax bracket who have equity investments than we ever realized. I am talking about the millions of employees who invest regularly through employee stock purchase plans and broad-based employee stock option plans. These plans are very different from ESOP, employee stock ownership plans. In the plans I refer to, employees purchase stock with their own aftertax money; and, unlike ESOPs, they are able to hold and vote their own stock.

Both stock options and stock purchase plans are widely used in growth-oriented companies like Bay Networks. However, the participation rate in these plans is hard to quantify, and yet a tremendous number of people are involved.

In his landmark study of employee ownership called "The New Owners," Rutgers professor Joseph Blasi says, "The seemingly quiet purchase of stock in a variety of non-ESOP defined contribution and defined benefit plans constitute almost half the employee ownership in public corporations."

Today CAEE is releasing a new study that begins to document for the first time how many employees are eligible to participate in companywide stock options and stock purchase plans. At our request, Executive Compensation Reports of Fairfax Station, Va., reviewed the proxy statements of more than 1,000 of the Nation's largest firms. They identified 80 firms that go out of their way to volunteer the fact that every employee in the company is eligible to participate in their stock option plan. These companies employ over 2.5 million people.

Additionally, another 230 firms offer section 423 employee stock purchase plans to all of their employees. So these 310 companies alone employ over 7 million people. The great majority of these people are the very middle-income taxpayers that H.R. 9 would help.

And this is just the tip of the iceberg. For every one of these major companies there are many smaller firms that offer stock options or stock purchase plans to all or nearly all of their work force. So we think it is fair to conclude that a politically significant population of middle-income people already have a major stake in this tax cut.

In fairness, I should say these numbers are far from exact, but it is also fair to say that I can't imagine a more effective way to expand the percentage of participation for middle-income people than to enact the capital gains incentive of H.R. 9.

Can I cite you evidence that employees really care about these plans? Yes, I can. Let me remind you that it was these little-noticed stock options and stock purchase plans that led to the recent conflict with the Financial Accounting Standards Board. Never before has FASB had to retreat from a proposal after issuing an exposure draft.

I would like to conclude by saying that cutting the capital gains tax will enhance the return on investments of many millions of middle-income American households. We thank you for proposing H.R. 9, and we urge you to pass it as quickly as possible.

[The prepared statement and attachment follow:]

Statement of David Lietzke
Vice President, Human Resources
Bay Networks Inc., Santa Clara, California
on Behalf of
The Coalition for American Equity Expansion

Before
The House Ways and Means Committee
January 25, 1995

Mr. Chairman, and members of this distinguished Committee. I am David Lietzke, Vice President, Human Resources for Bay Networks Inc.

About Bay Networks

Bay Networks is a new company reflecting the merger of Synoptics Communications of Santa Clara CA and Wellfleet Communications of Billerica MA, outside Boston. Our combined revenues exceed $1 billion. We employ about 3,000 people. Bay Networks designs, manufactures and sells computer networking equipment. Our equipment is a basic building block of the emerging information superhighway.

Like many other fast-growing technology companies. Bay Networks competes aggressively for the most talented and productive people at all levels in our organization. A key to our ability to attract and retain all of our employees is the opportunities we offer them to share in the growth of the company through our company-wide stock option plan and our employee stock purchase plan. At present 97% of our employees receive stock options and 74% have opted to purchase Bay Networks stock through our employee stock purchase plan.

About CAEE

I'm appearing before you today on behalf The Coalition for American Equity Expansion. CAEE is a group of growth-oriented companies and professional organizations dedicated to the promotion of equity compensation in the American economy. CAEE was a leader in the recent successful battle to prevent the Financial Accounting Standards Board from wounding America's best-managed companies by making their company-wide employee equity compensation plans prohibitively expensive.

SUMMARY OF TESTIMONY

Mr. Chairman, I'm not here to talk about what a capital gains tax cut would do for my company's tax return. I'm here because of the terrific benefit such a cut will provide to my company's employees and the employees of thousands of other firms with broad-based employee equity plans like ours.

The old charge that a capital gains tax cut just helps the wealthy is simply wrong. Your capital gains proposal would provide a significant tax cut for many millions of middle income American households. I'll offer two arguments to support that statement.

First, unlike the capital gains provision in current law, H.R.9 specifically extends a significant capital gains differential to middle income taxpayers in the 15 and 28 percent tax brackets. That's the right thing to do. This vital investment incentive shouldn't be restricted to people with the highest incomes as it is today.

Second, there are a lot more people in the 15 and 28 percent tax brackets with equity investments in plans sensitive to a capital gains cut than most of us realize. In the last 20 years there has been a huge increase in employees owning stock in their own companies through company-wide stock purchase plans and broad-based stock option plans. These non-ESOP employee ownership plans are widespread and growing, but they're hard to quantify. Their aggregate impact has escaped most of us because these plans don't have to be registered in any one place and because they don't generate a tax expenditure that forces them to be quantified and reexamined every few years.

"The seemingly 'quiet' purchase of stock in a variety of non-ESOP defined contribution and defined benefit plans constitute almost half the employee ownership in public corporations."

Joseph Blasi, *The New Owners: The Mass Emergence of Employee Ownership in Public Companies*, HarperCollins, NY, 1991, pg. 28

Today we are presenting a new study that begins to document how many more people are benefiting from stock options and stock purchase plans than is commonly recognized. A review of the proxy filings of 1,013 of the nation's largest firms reveals that nearly a third of these companies (310) already offer company-wide stock options or employee stock purchase plans to their employees. (Some companies offer both.) When we added up the numbers we were amazed to discover that these 310 companies alone employ over seven million people! See Appendix 1 & 2.

And we can show that this is just the tip of the iceberg. For every one of these giant companies with employee equity plans there are many smaller firms that offer stock options to all or nearly all of their workforce. And every Sec. 423 stock purchase plan is required by statute to be open to all employees after two years service. A series of industry surveys has documented this trend. Therefore, we think it's fair to conclude that a politically significant population of middle income people already have a major stake in this tax cut.

Cutting the tax on capital gains will increase the return tens of millions of middle income households receive from their equity investments. It will make employee equity programs much more valuable to both employees and companies. That will dramatically accelerate the spread of these programs and increase the income security of millions of additional families.

DISCUSSION AND DOCUMENTATION

I. The Populist Capital Gains Provisions of H.R. 9 Are More Equitable Than Current Law

Capital Gains Under the 1993 Tax Act

The Clinton Administration's Omnibus Budget Reconciliation Act of 1993 raised the top marginal tax rate from 31 percent to 39.6 percent, while keeping the top rate for long term capital gains at 28 percent. This had the beneficial effect of restoring a meaningful broad-based capital gains differential that encourages long term equity investment.

But the only people who have derived any benefit from this new differential are the tiny fraction of Americans with income that puts them into the tax brackets above 28 percent. To be helped by the 1993 provision, married taxpayers filing jointly, must have *taxable income* higher than $91,850—after all their deductions and exemptions. Single taxpayers must have a taxable income above $55,100 to benefit. As the supporters of the 1993 bill like to point out, its provisions only affected two percent of America's households. That approach provides no relief for the vast majority of Americans with mutual funds, employee stock purchase plans, stock options or homes to sell.

Under the 1993 tax act, taxpayers in the 15 and 28 percent tax brackets who sell assets they've held for several years are forced to pay tax on artificial gains caused by inflation. And they're taxed at their full ordinary income rates, while those in the top brackets enjoy a substantial break. Investment income earned over several years is taxed as if it had been earned in a single year, which can unfairly push taxpayers into higher tax brackets.

Capital Gains Under H.R.9

By contrast, H.R.9 offers a capital gains tax break for taxpayers at every income level. The bill would allow all taxpayers to exclude fifty percent of their gain on long term assets and pay tax on the remainder at their ordinary income rates. Taxpayers in the 15 percent bracket would pay an effective tax rate of 7.5 percent, those in the 28 percent bracket would pay 14 percent, and those in the 39.6 percent bracket would pay 19.8 percent on their capital gains.

The capital gains provision of H.R. 9 would build the U.S economy by encouraging the vast majority to Americans to make long term equity investments and prevent their gains from being destroyed by inflation. It offers a much more equitable approach than current law which reserves these vital incentives for those at the top.

II. Millions of Middle Income American Households Already Have a Stake in a Capital Gains Tax Cut Because of Company-Wide Stock Options and Stock Purchase Plans

What are Employee Stock Purchase Plans?

These statutory plans (IRC Sec. 423) allow employees to purchase their company's stock at up to a 15% discount, generally through payroll withholding. In an approved plan, after a holding period, taxes on the discount and any gain in the underlying stock are deferred until sale of the stock. At sale, the original purchase discount is taxed at ordinary income rates and any gain on the stock receives capital gains treatment. By law every employee with more than two years service must be allowed to participate equally in these plans. For example, at Bay Networks, we have a ceiling of $10,800 per year for employee stock purchases through our plan. Employees at all levels have the same ceiling.

What are Employee Stock Option Plans?

Employee stock options are rights granted to employees to purchase stock in their company for a specified time (no more than ten years) at a specific price (usually the fair market price of the stock at the time the option is granted.) Both stock option and employee stock purchase plans require shareholder approval.

Both these plans differ from ESOPs in that the employees purchase their own stock with after tax money. They hold and vote their own stock. They may sell it anytime or hold it. In the absence of a capital gains differential most employees today sell immediately when they purchase their stock. H.R. 9 would provide a strong tax incentive to encourage more employees to hold onto more of their stock after exercise to earn a better return.

Employee Equity Plans are Vitally Important to America's Growth Companies

Both stock options and stock purchase plans are widely used in growth-oriented companies. Stock options allow young, cash-strapped firms to start up and compete against more established companies for scarce technical talent. They help create new jobs by stretching scarce venture capital. Stock purchase plans allow employees to share in the growth of their company on a discounted, tax deferred basis. Equity ownership aligns the interest of employees with shareholders and creates an entrepreneurial climate that enhances competitiveness. This is employee empowerment through ownership. Employees in these firms aren't just a factor of production called "labor," they're stakeholders.

Company-wide stock options and stock purchase plans are the greatest mechanism for sharing wealth since the family farm. Their emergence is a uniquely American development. None of our foreign competitors have yet learned how to generate the kind of company-wide employee commitment and creativity that these plans generate. As Senator Lieberman said during the recent FASB debate, "Employee equity is America's edge in global competition. It's our secret weapon."

FASB Can Vouch For The Intense Commitment of Both Employees and Companies to These Plans

If some of these arguments sound familiar, it's because you heard a lot of them recently during the battle over FASB's attempt to change the accounting treatment of these very plans. In its twenty year history FASB had never had to retreat from a proposal after issuing an exposure draft. But when they threatened to extinguish these broad-based plans, they were inundated and eventually overcome by the intensity of the opposition of America's growth companies.

And what a boring topic to get excited about! Most people would rather snort a skunk than have to get up to speed on an accounting issue—but not this one. It's hard to imagine a rally in Silicon Valley—the first ever, on any topic—with over four thousand people from 130 companies turning out—with a marching band—to protest an esoteric accounting change. But that's what happened.

I want to emphasize that it was the threat to company-wide stock options and stock purchase plans that generated this unprecedented war. No one fought FASB over ESOPs. They weren't affected. No one fought FASB to save their 401(k). They were barely affected. What was threatened was the chance for rank-and-file employees to share an equity stake in their own companies. It's this populist dimension and the widespread use of these plans that made fixing the FASB problem a political priority in states like California, Texas, New Jersey, Oregon and Washington.

While I'm here, I'd like to personally thank the members of this committee who helped persuade FASB to withdraw its damaging proposal. We're especially grateful to those who sponsored H.R. 2759, The Equity Expansion Act: **Mr. Payne, Mrs. Johnson of Connecticut, Mr. Archer, Mr. Herger, Mr. Johnson of Texas, Mr. McDermott, Mr. Thomas, and Mr. Zimmer.** Your work on that issue has made it possible for millions of American families to continue to benefit from broad-based employee equity plans that would have disappeared under FASB's proposal.

Nearly a Third of the Nation's Largest Firms Already Offer Stock Options or Stock Purchase Plans to All Their Employees

Mr. Chairman, when we set out to try to make these non-ESOP employee equity programs more visible to you, we had no idea what big numbers we'd be uncovering. But the employment of these giant firms really adds up.

Fortunately, we learned that Executive Compensation Reports, of Fairfax Station, Virginia regularly reviews the proxy statements of more than a thousand of the nation's largest firms taken from *Fortune 500* Service and Industrial lists, and the *BusinessWeek* Corporate Scoreboard 1,000. At CAEE's request, ECR examined 1013 major firms, using its ECRInfo data base. They identified 80 major firms that report their entire workforce is eligible to participate in their stock option plan. When we checked the employment these companies report to *Standard and Poor's*, we discovered they employ over 2.5 million people! These firms are listed in Appendix 1.

ECR was also able to identify 230 that offer Section 423 employee stock purchase plans to all of their employees. Even though a few of these companies don't list their employees with *Standard and Poor's*, the rest employed over 4.5 million people in 1994. They are listed in Appendix 2. That's a total of over 7 million people from just these 310 companies!

(We deleted companies that offer both company-wide stock options and stock purchase plans from the purchase plan list and counted them only once in the combined total.)

Over 7 Million Employees are Eligible to Benefit From the Capital Gains Cut From These Large Companies Alone

Since both stock options and 423 plans share the same equity investment characteristics, it's fair to say that over 7 million employees of these major firms have a direct stake in the capital gains tax cut that is before you. In almost all of these companies, the great preponderance of the employees are in the middle income categories that H.R. 9 targets for relief.

Mr. Chairman, I hope you and the other members of this Committee will look at this list. You're likely to find constituent companies and other allies of yours that grant stock options and option-like stock purchase plans to their entire workforce. Please remember this list the next time someone tries to tell you that stock options are just a rip-off for fat cats.

Many Smaller Firms Offer Broad-Based Employee Stock Plans

For every one of these giant firms that offer company-wide equity compensation programs, there are many smaller companies doing the same thing. They're just harder to quantify. A series of industry surveys consistently shows that smaller growth-oriented firms use broad-based employee equity programs extensively.

As part of the effort to persuade FASB to drop its proposal, in November 1993, the NASDAQ Stock Market surveyed the companies it lists and received a large response (2185, almost 53% of their listed companies). Significantly, a full 30 percent of these companies reported that if FASB dropped its proposal,s they planned to broaden the scope of their stock option plans to include lower levels of employees. And this was before a capital gains tax cut, which should accelerate that trend even more.

More recently an electronics industry survey by the American Electronics Association and ShareData in September 1994 received 600 respondents. Over 300 of those companies grant stock options to all their employees. 83.3% of the companies with fewer than 100 employees grant options to every employee. Employees below the senior management level received 65% of all the stock that was granted by all the companies. A 1990 survey by the Biotechnology Industry Organization found that 75% of its companies used stock options and 60% granted them to their entire work force.

It's also important to notice that professional venture capital firms are strong advocates of broad-based employee equity plans. American venture capitalists are among the most sophisticated corporate investors, directors and shareholders in the world. They consistently insist that their portfolio companies establish and maintain extensive employee stock compensation plans that cover all or nearly all of their work force. And they're not hesitant to say why. The professional venture capital industry has learned over the years that broad-based employee stock ownership is essential to achieving the dramatic returns that professional venture capital investors seek.

H.R. 9 Will Increase Participation in Existing Plans

Mr. Chairman, I want to emphasize that we're not able to give you precise numbers here. We're just trying to help you see an important movement in the economy that has been under reported in the past. We recognize that these employment numbers overstate the population that actually benefits from these programs today. First, these are world-wide employment figures. Some of the people included live in other countries and may or may not pay U.S. taxes. We couldn't adjust for that in time for this hearing. Second, we know that not all employees choose to participate in their company's plans today. But I can't think of a more effective way to expand the percentage that do participate than to enact the capital gains incentives of H.R. 9.

CONCLUSION

FASB's proposed accounting change left a cloud of uncertainty over equity compensation programs in the U.S. for a full decade. Despite that, these plans continued to proliferate because they're so valuable to employees. The demise of FASB's threat, combined with a significant new capital gains tax incentive, could usher in a golden age of employee ownership and employee empowerment.

We strongly urge you to enact the capital gains provisions of H.R.9.

C A E E

The Coalition for American Equity Expansion

1155 15th St. NW, Suite 710, Washington, DC 20005 (202)659-9101 Fax (202)775-9078

Appendix 1

80 Major Firms With Employee Stock Option Plans Open to All Employees

Company with number of employees

Advanced Micro Devices	11,880
AirTouch Communications	n/a
Allied Signal Inc	88,380
Amgen Inc	2,335
Amoco Corporation	47,000
AST Research Inc	2,655
Avnet Inc	6,700
Baker Hughes	18,600
Bed Bath & Beyond, Inc	1,800
Beverly Enterprises	100,000
Best Buy Co., Inc	3,500
Block, Inc	82,000
Boeing Co	143,543
Brinker International	12,400
Chesapeake Corp/Virginia	5,082
Cintas Corp	7,000
Cirrus Logic, Inc	478
Clark Equipment Co	6,306
Century Communications	2,000
Consolidated Papers	4,782
Commonwealth Edison Co	18,000
Compaq Computer	9,500
Computer Sciences Corp.	28,000
Crestar Financial Corp	6,486
Cyprus Amax Minerals	7,011
Dana Corp	35,000
Data General Corp.	8,520
Dell Computer Corp	1,300
Dexter Energy	605
Dupont (E.I.) de Nemours	135,000
Duracell International	9,000
Edwards (A.G.)	10,029
Eastman Chemical Co	12,000
Equifax Inc	12,400
Ethyl Corp	6,000
Forest Laboratories, Inc	1,300
GEICO Corp	7,322
General Mills, Inc	110,000
Helene Curtis Industries	3,300
Hewlett-Packard Co	94,900
Honeywell,Inc	55,440
Huntington Bancshares	6,819
INCERA Group Inc	10,000
Intelligent Electronics	635
Itel Corp	24,600
Jostens, Inc	9,000
Kansas City Southern Inds	3,724
Kellogg Co	16,500
Kemper Corp	9,500
Kroger Co	170,000
Lotus Development Corp *	4,000
Marion Merrell Dow	9,122
Masco Corp	9,000
Medtronic, Inc	6,308
Meredith Corp	2,200
Merck & Co, Inc	38,400
Minnesota Mining & Mfg Co	87,015
Nordson	2,937
Oracle Systems Corp	8,160
Outboard Marine Corp	8,449
Pacific Enterprises	9,800
PepsiCo, Inc	308,000
Perkin-Elmer Corp	6,000
Pfizer, Inc	42,000
Premark International	22,000
QUALCOMM Inc	619
Rohr Industries	7,000
Scott Paper Co	28,900
Southtrust Corp	6,454
Texas Instruments, Inc	60,577
Tosco Corp	1,760
Toys "R" Us	80,000
TRINOVA Corp	15,923
Union Texas Petroleum	1,000
USF&G Corp	n/a
Vons Companies, Inc	26,000
Wal-Mart Stores, Inc	386,000
Wang Laboratories,Inc	16,757
Warnaco Group, Inc	11,700
Warner-Lambert Co	33,000

Appendix 2

230 Major Firms With Employee Stock Purchase Plans Open to all Employees

Company with number of employees

ADC Telecommunications	2,308
American Elec Power Inc	2,441
American Internat'l Group	32,000
Alco Standard Corp	28,500
Alltel	12,876
Alexander & Baldwin	3,128
Alza Corp	1,030
Amdahl Corp	8,400
American Medical Holdings	30,600
American Premier Underwrt	n/a
Anacomp, Inc	5,500
Analog Devices, Inc	5,300
Andrew Corporation	3,000
Anheuser-Busch Cos	44,538
Applied Materials, Inc	3,909
Apple Computer	14,938
Armstrong World Industr's	22,500
American Tel & Tel Co	312,700
Automatic Data Processing	21,000
Autodesk, Inc	1,608
Ball Corp	14,000
Baxter International, Inc	61,300
Beckman Instruments, Inc	6,900
Belo (A.H.)	2,788
Beneficial Corp	6,800
Biogen, Inc.	380
BJ Services Company	2,600
Bank of New York Co., Inc	12,847
Brooklyn Union Gas Co	3,626
Black & Decker Corp	38,500
Bank South Corp	2,898
Boatmen's Bancshares, Inc	8,400
Burlington Northern Inc	32,000
Cablevision Systems Corp	4,500
Cabletron Systems	1,300
Capital Cities/ABC, Inc	19,250
Carnival Cruise Lines	1,400
CBI Industries, Inc.	14,000
Centerior Energy Corp	8,582
Charming Shoppes, Inc	8,300
Chiquita Brands Internat'l	45,000
Chiron Corporation	1,900
Chemical Banking Corp	39,687
Chris-Craft Industries	1,200
Chubb Corp	10,100
Circuit City Stores Inc	30,000
Cisco Systems, Inc.	1,241

Citicorp	88,500
Citizens Utilities	2,300
CML Group, Inc	5,000
Continental Bank Corp	4,158
Coastal Corp	19,700
Columbia/HCA Healthcare	6,300
COMSAT	1,644
ConAgra, Inc	80,787
Conner Peripherals, Inc	3,000
Consolidated Edison - NY	18,718
Cooper Industries, Inc	50,000
Corning Inc	32,500
Cray Research, Inc	5,000
CUC International	6,000
Cummins Engine Co, Inc	23,400
Dauphin Deposit	2,127
Deere & Co	34,500
Deluxe Corp	17,400
Digital Equipment Corp	124,000
Donnelley (R.R.) & Sons	2,500
Dow Chemical Co	62,000
Dow Jones & Co, Inc	9,400
Eastern Enterprises	4,300
Edwards (A.G.)	10,029
EG&G, Inc	30,000
Engelhard Corp	6,400
ENSERCH Corp.	11,000
First Bank System	10,337
Food Lion	60,000
Federal Express Corp	93,000
Federal Home Loan	50
Federal Nat'l Mortgage Assn	2,400
First Fidelity Bancorp	135
First Financial Mgmt Corp	9,600
First Security Corp	5,606
Fleming Cos, Inc	22,900
Flight Safety Internat'l	2,500
Fourth Financial Corp	2,100
First Chicago Corp	17,000
First Union	23,459
G-I Holdings	4,163
Georgia Gulf Corp	1,074
Georgia-Pacific Corp	52,000
Gateway 2000	n/a
Genentech, Inc	n/a
GTE Corp	131,000
Hannaford Brothers Co	14,000
Hanson Inds. N. America	41,000
Hercules Inc	72,000
Holnam	3,000
Home Depot	45,000
HON Industries	5,700
Hudson Foods	7,659
Hunt (J.B.) Trans Svcs	8,478
International Bus Machine	301,000
Imperial Holly Corp	1,840
Inland Steel Industries	12,000
Integra Financial Corp	5,000
Intel	24,600
Interpublic Group of Cos	16,500
Intergraph	10,000

John H. Harland Co	6,200
James River Corp of VA	39,000
Kaman	5,424
KLA Instruments Corp	950
Knight-Ridder, Inc	22,000
Lafarge	8,300
Louisiana-Pacific Corp	13,000
Legent Corporation	2,000
Leggett & Platt, Inc.	11,400
Long Island Lighting Co	6,600
Limited, Inc	90,000
Lincoln Electric Co	6,800
LG&E Energy Corp	n/a
LSI Logic Corp	3,300
Lubrizol Corp	4,800
M/A-COM Inc	4,763
Marriott International	21,000
Martin Marietta Corp	55,670
Maytag Corp	21,407
McCormick	7,501
MCI Communications	34,000
McKesson Corp	14,150
Medtronic, Inc	6,303
Mercantile Bancorp	4,417
Mercury Finance	572
Merrill Lynch & Co	40,000
Microsoft Corp *	12,500
Midwest Resources, Inc	3,100
Miller (Herman)	5,400
Minnesota Mining & Mfg Co	87,015
Minnesota Power & Light	3,200
Marshall & Isley Corp	6,001
Marsh & McLennan Cos, Inc	25,800
National Gypsum Co	n/a
NICOR, Inc	3,500
NIPSCO Industries, Inc	4,648
NorAm Energy Corp	n/a
Novell Corp	3,500
National Semiconductor	26,200
New York State Elec & Gas	4,888
New York Times Co	10,100
Office Depot, Inc	12,400
PacifiCorp	15,216
Pacific Telecom	21,891
Pennzoil Co	11,694
Pentair	8,700
Peoples Energy	3,441
Philip Morris, Inc	161,000
Pier I Imports	10,350
Pittston Co	20,100
PNC Bank Corp	18,815
Policy Management Systems	4,363
Portland General Corp	2,745
Price (T.Rowe) Assoc	1,371
Public Serv Enterprise Gp	12,761
PSI Resources, Inc	n/a
Quantum Corp	1,752
Questar Corp	2,658
Raychem	10,000
Reader's Digest Assn, Inc	7,400
Reebok International Ltd	4,200

Reliance Electric	14,000
Ryder System, Inc	40,000
Safety-Kleen Cor	6,800
Salomon Inc	8,900
Schlumberger Ltd	51,000
Scientific-Atlanta Inc	3,000
SciMed Life Systems, Inc	1,300
Seagate Technology	39,000
Service Corp Internat'l	11,500
ServiceMaster Ltd Partners	21,800
Shoney's, Inc	29,000
Signet Banking Corp	4,697
Silicon Graphics	3,400
St. Jude Medical, Inc	674
Snap-On Tools Corp	7,000
SONAT	4,000
Sprint	50,000
Stanley Works	19,000
Storage Technology Corp	1,300
Stride Rite Corp	3,700
Sunbeam-Oster Company Inc	11,000
Sun Microsystems, Inc	12,500
Southwest Airlines Co	11,400
SynOptics Communications	1,700
SYSCO Corp	23,000
Tambrands	3,800
Tandem Computers	10,784
Tandy Corp	41,000
Tektronix, Inc	10,200
Tele-Communications	34,000
Telephone & Data Systems	3,803
Teradyne, Inc	4,150
Texas Instruments, Inc	60,577
Thermo Electron Corp	6,166
Torchmark Corp	5,968
Transatlantic Holdings	240
The Travelers, Inc	30,000
Tribune Co	12,900
Triton Energy Corp	945
Total System Services	750
Tyson Foods	49,686
Universal Corp	n/a
United States Cellular	180
United HealthCare Corp	3,113
Universal Foods Corp	5,400
United States Surgical Co.	8,100
UNUM Corp	7,000
UtilCorp United	4,300
Vanguard Cellular Systems	600
Varian Associates	9,300
Wallace Computer Services	3,300
Walgreen Co	50,000
Wells Fargo & Co	21,300
Western Digital Corp	7,300
Willamette Industries	12,000
Winn-Dixie Stores, Inc	39,000
Woolworth Corp	74,000
Washington Water Power Co	1,401
Westinghouse Elec Corp	109,000
Xilinx, Inc	550
York International	12,500

Sources

Company Listing: ECRInfo data base, Executive Compensation Reports, Fairfax Station, Virginia

Employee Numbers: *Standard & Poor's Register of Corporations*, Vol 1, 1994
McGraw-Hill Inc., NY, NY
n/a = not available in S & P
* American Electronics Assn. 1994 Membership Directory

Mr. ZIMMER. Thank you.

The next witness is Richard Herring, vice chair for advocacy, National Small Business United, and general manager of the Gloucester Co., Franklin, Mass.

STATEMENT OF RICHARD HERRING, VICE CHAIR FOR ADVOCACY, NATIONAL SMALL BUSINESS UNITED; AND GENERAL MANAGER, THE GLOUCESTER CO., INC., FRANKLIN, MASS.

Mr. HERRING. Thank you, Mr. Chairman and members of the committee.

As you say, I am Richard Herring. I am general manager of Gloucester Co., Inc., in Franklin, Mass. Gloucester Co. employs 40 and is a small manufacturer of caulking compound. Our caulking compounds are under the brand name of Phenoseal.

In New England, I am a past board member of the Smaller Business Association of New England, which is a member association of National Small Business United. Nationally, I serve as vice chair for advocacy for National Small Business United.

We at National Small Business United very much appreciate the opportunity to be here. NSBU represents over 65,000 small businesses in all 50 States. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. We have always worked on a bipartisan and proactive basis. In addition to individual small businessowners, the membership of our association includes local, State and regional small business associations across the country.

Discussion of the enormous use of informal and middle-class investors in small business raises one of the most hotly debated and widely misstated products of a capital gains differential, that it primarily benefits the wealthy. The statistics suggesting that recipients are rich are misleading. Many small businessowners work a lifetime to build a growing and successful business. The business' one-time sale is a capital gain, but it really represents a lifetime of earnings that got ploughed back into the business to make it grow and to create jobs. To be sure, 1 year's income with a capital gain may seem substantial but is not recurring and does not make them rich.

Let me discuss Gloucester Co. a little bit. When my father decided to start Gloucester Co., he had no investment. There were no venture capitalists interested in helping him start his business. Gloucester Co., in essence, was just another undercapitalized small business.

Over the first 5 years, my mother and my father reinvested all their earnings to grow the company. Today, 35 years later, Gloucester Co. still believes in ploughing our earnings back into the company; and, as a result, we are now seeing the success of those earlier years.

The question today is this: Should reinvestment be encouraged or discouraged? Currently, the capital gains tax discourages reinvestment. And while the proposed cut in capital gains recommended in the Contract With America encourages reinvestment, what I would propose is that a long-term, graduated capital gains tax will do more to reward reinvestment.

More importantly, we must realize that small businessowners face regular decisions about how much income to take out of the business and how much to reinvest back into business growth and expansion.

To the extent that investment and other income are taxed at the same rates and given the time value of money, the Tax Code strongly encourages businessowners to take profits now and not wait for future growth. This mistake is a fundamental one that can have a profound effect on the ability of a business to grow and create jobs.

In order to make the taxation of capital gains beneficial for investment, NSBU has long recommended the establishment of a broad-based capital gains exclusion, such as the one proposed in the GOP Contract. But in order to assure that the exclusion is helping long-term investment rather than short-term gain, NSBU has further recommended the graduation of that differential based on the holding period of the asset. Essentially, we would lower the rate as the holding period rises.

The proposal in the Contract would give all capital gains the same reduced tax rate. While this is certainly beneficial to small business, focusing the proposal on long-term gains would maximize its benefits. Such a structure might also reduce or eliminate the statically scored revenue loss attributed to a capital gains rate reduction.

One of the ways that the proposal could help long-term investment and small business is indexing gains to inflation. This provision exclusively benefits long-term gains, and capital gains in small businesses are almost exclusively long term.

The indexing debate is about fairness. A small businessowner should not be taxed on profits that come only from inflation and have not been truly realized. This problem was fixed for ordinary income tax "bracket creep" almost 15 years ago. It is time to correct this inequity on the capital gains side as well.

Thank you.

[The prepared statement follows:]

Statement of
Mr. Richard Herring, Gloucester Company
Franklin, Massachusetts
Before the House Ways & Means Committee
Regarding Capital Gains & Other Small Business Tax Issues
On Behalf of National Small Business United

January 25, 1995

Mr. Chairman and Members of the Committee:

My name is Richard Herring, and I run the Gloucester Company in Franklin, Massachusetts. The Gloucester Company is a small manufacturer of caulking compounds. In New England, I am a board member of the Smaller Business Association of New England (SBANE). Nationally, I serve as the Vice Chair for Advocacy for National Small Business United (NSBU). We at NSBU very much appreciate the opportunity to be here.

National Small Business United represents over 65,000 small businesses in all fifty states. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. We have always worked on a bi-partisan and pro-active basis. In addition to individual small business owners, the membership of our association includes local, state, and regional small business associations across the country.

We are here today to address small business tax policy, chiefly the capital gains tax. First, I would like to make some general comments about the tax code. Though NSBU had many serious concerns about the 1986 Tax Reform (such as the elimination of a capital gains differential), NSBU was very encouraged by one aspect of its passage: there was an attempt by the framers of the 1986 Tax Reform Act to elevate the new code to a more permanent status and resist significant future change. We all know that this protection of the code did not last long. After the relatively significant tax code changes in 1990 and again in 1993, it must be recognized that the present tax system has become a fluid set of rules which bend to influence. But business owners need a clear set of rules they can count on for the future. This need is even greater for taxes with long-term implications, such as capital gains taxes. If capital gains reform is enacted in this Congress, there must be a long-term commitment to keep the new rules in place.

When the next major tax debate is over and a new tax code is in place, we should make a stronger national commitment to its permanence. The underpinnings of any tax code are supposed to be simplicity, fairness, and consistency. While we are always debating our system's adherence to the first two principles, we clearly violate the third. Small businesses simply cannot cope with the ever-changing nature of the tax code.

Given this overview, I will next try to make the clear small business case for a capital gains tax rate reduction, especially on long-term investments. In addition, I will take this opportunity to comment on several other small business tax proposals found in the Contract with America and add some additional ideas, as was suggested by the Committee.

♦ Capital Gains

A reduction in the capital gains rate is critical for the economic future of this country and its small businesses. The economic boom of job creation witnessed especially during the first half of this decade was mostly a product of small businesses, and a reduced capital gains rate will add the necessary incentive for small businesses to continue start-ups, growth, innovation, and job creation.

The bases of small business success have traditionally been entrepreneurship, innovation, and risk-taking. For these elements to occur in unison, they must be properly rewarded. Few things can provide that reward better than a capital gains differential, as has been recognized since 1921 when the differential was first introduced. But the tax reform measures of 1986 brought elimination of any capital gains differentials or exclusions. In the last few years, a capital gains differential has come into existence, only because ordinary income tax rates have risen, while the top capital gains tax rate has remained at 28 percent. In addition, a smaller targeted capital gains tax cut was passed as part of the 1993 law. This provision allows an individual who invests in the original issue of stock from a "C" Corporation valued at less than $50 million and holds it for five years to exclude half of the gain from taxation. But this provision is of no benefit to the S Corporations, partnerships, or sole proprietorships which constitute the lion's share of the small business community.

Capital gains incentives have traditionally been seen as a tool of venture capitalists and wealthy investors. But we must remember the vast networks of informal investors in the small business community. Research conducted by the Small Business Administration shows that informal equity investors in small firms are a much larger financing factor than venture capital. Annual informal investment is very conservatively estimated to be 2 to 3 times the $4 billion invested annually by venture capital companies in the U.S. Other studies have estimated the annual flow of informal equity to be over $30 billion.

One of the primary impediments to the economic success of smaller enterprises is the incredible scarcity of capital for that sector. Banks either will not provide funds for small businesses (finding it too risky) or will only provide the necessary capital at prohibitively high interest rates or under other adverse terms. Meanwhile, venture capitalists require enormous growth potential for most of their investments. So, most small business capital comes from family, friends, and the personal resources of small business owners. The capital gains tax levied on these people can reduce their incentive to invest in the first place. A reduction in the capital gains rate would not only give some relief to these overburdened individuals, it would also create additional entrants into the small business capital markets.

Discussion of the enormous use of informal (and middle class) investors in small business raises one of the most hotly debated and widely misstated products of a capital gains differential: that it primarily benefits the wealthy. The statistics suggesting that recipients are rich are misleading. Many small business owners work a life-time to build a growing and successful business. That business' one-time sale is a capital gain, but it really represents a lifetime of earnings that got plowed back into the business to make it grow and to create jobs. To be sure, that one-year's income (the one with the capital gain) may seem substantial, but it is not recurring, and it certainly does not make them "rich."

More importantly, we must realize that small business owners face regular decisions about how much income to take out of the business and how much to reinvest back into business growth and expansion. To the extent that investment and other income are taxed at the same rates (and given the time value of money), the tax code strongly encourages business owners to take profits now and not wait for future growth. This mistake is a fundamental one that can have a profound effect on the ability of a business to grow and create jobs.

In order to make the taxation of capital gains beneficial for investment, NSBU has long recommended the establishment of a broad-based capital gains exclusion, such as the one proposed in the GOP Contract. But, in order to assure that the exclusion is helping long-term investment rather than short-term gain, NSBU has further recommended the graduation of that differential based upon the holding period of the asset. Essentially, we would lower the rate as the holding period rises. The proposal in the Contract would give all capital gains the same reduced tax rate. While this is certainly beneficial to small business, focusing the proposal on long-term gains would maximize its benefits. Such a structure might also reduce (or eliminate) the statically scored revenue loss attributed to a capital gains rate reduction.

One of the ways that the proposal could help long-term investment in small business is indexing gains to inflation. This provision exclusively benefits long-term gains, and capital gains in small businesses are almost exclusively long-term. Really, the indexing debate is about fairness. A small business owner should not be taxed on "profits" that have come only from inflation and have not been truly realized. This problem was fixed for ordinary income tax "bracket creep" almost 15 years ago. It is time to correct this inequity on the capital gains side as well.

- **Taxes on Estate**

An issue of long-standing concern for many small business owners is the tax on inherited property. For years, families have been faced with the problem of liquidating the family business in order to pay for the taxes on its inheritance. In order to help these small business owners pass on their businesses in its entirety, the federal government has allowed the first $600,000 of an inherited company's worth to be nontaxable. The problem, of course, is that many small businesses are worth much more than $600,000, and liquid assets for taxation can be hard to come by. Furthermore, this exemption was instituted more than a decade ago, and inflation has greatly diminished its value since that time.

NSBU is supportive of the Contract's proposal to raise the exemption (really, the unified credit) level to $750,000 and index it for inflation. This step will halt the erosion in the tax position of many small family businesses. But NSBU is eager to find more innovative and equitable ways to allow the continuation of family businesses. For instance, there have been proposals to treat tangible, illiquid, productive assets (such as a small business) more generously than other assets (such as cash or collectibles) for estate tax purposes. One way of doing this is to eliminate the tax entirely for the inheritance of a family business (with a carryover basis) as an elective alternative. Not only would such a change make it easier for a small business to survive the death of a principle owner, it would encourage others to make productive investments with their assets.

- **Improving Depreciation: Expensing and Neutral Cost Recovery**

The Contract with America contains a very helpful small business provision, an increase in "expensing" from a maximum of $17,500 per year to $25,000 per year. This provision allows small businesses to immediately deduct (expense) this amount of equipment purchase in the year of the transaction. This increased deduction would be very helpful for cash-strapped small businesses that are ready to grow and improve or enlarge their capital base. Increased ability to expense these investments should enhance the long-term productivity of American small business, and we recommend that the expensing provision be further increased to perhaps as much as $100,000.

Another proposal in the Contract is called neutral cost recovery, which essentially factors inflation into the depreciation schedule and allows businesses to claim, in the long run, more depreciation than the actual cost of the asset. Under the scheme, depreciation would be less in the early years, but considerably higher in the out years. This new depreciation system is very complex, which greatly reduces that likelihood that small businesses will make wide use of it. The backloading effect of the benefit is also likely to be unpopular with small businesses, since they often have poor cash flow and a limited line of credit. In general, small businesses would prefer to have an immediate write-off (such as the expensing provision) or at least be allowed to write-off depreciation sooner rather than later. While there may be small businesses who can benefit, it appears that this provision was primarily written with certain large industries in mind. But there is another alternative which would create a strong investment incentive and relatively little real revenue cost: a business expansion tax deferral.

Given the need for both tax-based incentives to encourage business growth and expansion and continued deficit reduction, new and creative tools need to be identified that fit both of these bills. Following is one idea that could create exactly this sort of win-win situation: a business expansion tax deferral.

There should be a dollar-for-dollar one year deferral of all net income tax liabilities, to the extent that there are increases in net depreciated value of fixed assets (other than real estate) and the book value of inventory. In other words, for every dollar that a business increases its net assets by investing in plant and equipment, it can defer a dollar of federal income tax. Since such a plan does not reduce total tax liabilities, a fair model would score it as at least budgetarily neutral over time; if the economic growth the deferral will stimulate were counted, there would be revenue gains. But since the plan would ease tax burdens *in the years in which growth is actually occurring*, economic growth should be markedly strengthened. Though the deferral would only extend for one year, further increases in net depreciated assets could further extend the deferral.

Further details of the plan include:

1. The deferral amount would be based upon the net increase in the depreciated value of the fixed assets and the tax basis of the inventory;
2. If the increase exceeds the tax liability, the excess could be carried over.
3. In order to avoid taxpayer "game-playing", the immediately preceding year's

decrease in assets would be subtracted from the current year's increase in assets, so that taxpayers would not plan their acquisitions only in alternate years.

4. The tax deferral would be interest free.

We believe this idea holds a great deal of promise. The deferment could be a great help to rapidly growing companies (the ones where most of the job gains occur) while not seriously affecting total federal revenues over time. We hope the Committee will be able to give it serious attention.

- **Home Office Deduction**

NSBU was very pleased to see that the Contract deals with correcting the current inequity in the home office deduction. Created by a Supreme Court ruling two years ago, the new interpretation of the deduction greatly restricts the ability of a home-based business to take an appropriate deduction for the use of their home as an office. The language in the Contract should be very helpful to these businesses and should effectively address the issues raised by the Court's ruling.

- **Health Care Deduction for the Self-Employed**

This Congress holds out the very real hope that the 25% deduction for the health insurance expenses of the self-employed can finally be made permanent and ultimately raised to a full 100%. We are very happy that Chairman Archer has indicated his desire to move forward with retroactive enactment of the 25% deduction.

The annual ritual of suspense and last-minute decisions surrounding whether this deduction will be extended is frustrating, unnecessary, and unprofessional. Right now, *there is no health care deduction for the self-employed*. It expired at the end of 1993, and did not get renewed in 1994. If nothing is done soon, April 15 will come and go and small business owners will miss an important deduction on which they have come to rely. The temporal nature of this deduction always makes it a likely target for elimination when Members go shopping for the revenues to off-set some favorite tax break or spending project. The deduction cries out to be made permanent simply for procedural reasons; but there are also strong policy and fairness issues which compel us to the conclusion that the deduction should be made permanent--and expanded to 100%.

Thank you for holding this hearing and giving NSBU a chance to relay its views on tax policy. Please contact us if we can be of any further assistance.

Mr. ZIMMER. Thank you, Mr. Herring.

The next witness is Robert J. Beckman, chairman, emerging company section of Biotechnology Industry Organization, and president and CEO of Intergen Co. in Purchase, N.Y.

STATEMENT OF ROBERT J. BECKMAN, CHAIRMAN, EMERGING COMPANY SECTION, BIOTECHNOLOGY INDUSTRY ORGANIZATION; AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, INTERGEN CO., PURCHASE, N.Y.

Mr. BECKMAN. Thank you, Mr. Chairman.

My name is Robert J. Beckman, and I am chairman of the emerging company section of the Biotechnology Industry Organization. I am testifying on behalf of BIO and the emerging company section, which is the entrepreneurial segment of that industry, and as president and chief executive officer of Intergen and as an entrepreneur.

My testimony will outline tax incentives for capital formation for entrepreneurs in emerging companies which has been endorsed by BIO. BIO represents about 600 companies of all segments of the biotechnology industry—biomedicine, bioagriculture and bioremediation.

My own company began in December 1987, with only eight employees. Today, we support jobs in three States with five manufacturing and distribution facilities, three offices in Europe and a partnership in Kobe, Japan, if it is still standing.

Intergen's biological products are used in innovative research throughout the world and could be found in breakthrough therapies and detection systems for things like cancer, heart disease, hemophilia, hepatitis and other important diseases.

I understand that my prepared testimony will be part of the record, so I will limit my discussions today on only one of four tax policy recommendations that BIO is making.

The issue for entrepreneurs in the biotechnology industry really is very clear. It is capital formation. Bringing a biotechnology drug to market today is a very lengthy and costly process. It takes about 10 to 12 years at a cost of $150 to $360 million to bring a drug to market.

After raising enormous amounts of capital, conducting cutting-edge research and lengthy and very costly clinical trials, a company can find that its product is not approvable by the FDA. And even if it is approved there is no assurance that there is going to be market success. So risk in our industry is extraordinarily high.

Unfortunately, our industry right now is in the middle of one of its worst financial crises. We believe largely because of the threat of drug price controls in the health care debate last year. In the past 2 years, the AMEX biotechnology stock index has declined over 50 percent. This trend has deprived most biotechnology companies of the ability to raise sufficient capital to continue their research. Many are close to broke.

Because of this urgent problem, I want to focus not on broad-based tax incentives, which I think we have seen a tremendous amount of support, but we would also like to talk about a targeted capital gains exclusion.

We support the enactment of the capital gains incentive which is included in the Contract With America, but we also support a second tier, perhaps more powerful incentive, targeted at direct investments in the stock of emerging companies. We support both incentives because in our industry we depend almost exclusively on direct equity investment to fund our research.

BIO's proposal for a two-tiered capital gains incentive originated with Senator Packwood in 1989. He proposed that qualified venture capital stock held for 4 or 5 years receive a gains tax reduction which was roughly twice as great as the incentive for nonventure capital stock.

The definition, by the way, of venture capital stock was based on a capital gains bill proposed by Senator Bumpers and Congressman Matsui. During the 1992 Presidential campaign this same venture capital incentive was later endorsed by President Bush, Governor Clinton and Senator Gore. Others who have endorsed the targeted incentive were the National Federation of Independent Businesses, the National Venture Capital Association and the American Electronics Association.

Unfortunately, after the election, drastic limitations were included in a 1993 budget reconciliation bill which, although enacted, effectively gutted the incentive. It reduced the market capitalization ceiling. It did not provide an incentive for corporate taxpayers, who are major investors in our industry. It imposed dollar limits on the benefits to any individual taxpayer. It did not provide enough of an exemption for the alternative minimum tax, and the working capital rules are simply not workable. As a result, the biotechnology industry has been unable to use this incentive at all in raising capital.

We are delighted that Congress is poised to finally enact across-the-board capital gains tax reduction. We support that. BIO also continues to support a supplementary targeted gains incentive. This targeted gains incentive would assure there exists a distinct and more powerful incentive for high risk, long-term investments and entrepreneurial firms and emerging companies.

Thank you.

[The prepared statement follows:]

TESTIMONY OF ROBERT J. BECKMAN
CHAIRMAN, EMERGING COMPANY SECTION
BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)
AND
PRESIDENT AND CEO OF INTERGEN COMPANY
PURCHASE, NEW YORK

My name is Robert J. Beckman and I am Chairman of the Emerging Company Section of the Biotechnology Industry Organization (BIO). I am testifying today on behalf of BIO and its Emerging Company Section and as President and CEO of Intergen Company of Purchase, New York.

My testimony will outline tax incentives for capital formation for entrepreneurs and emerging companies endorsed by BIO. BIO represents 570 biotechnology companies and others involved in every sector of the biotechnology industry -- biomedical, bioag, bioremediation and bioenzymes. BIO's Emerging Company Section, which I chair, has 216 members ranging in size from one person virtual companies to well-established medium-sized biotech companies with approximately 150 employees. The principal role of this entity within BIO is to focus attention on entrepreneurial issues affecting emerging biotech companies, recognizing that many of these companies are responsible for the innovative research which has led to new breakthrough biotech products.

Intergen as an Entrepreneurial Company

Our company, Intergen, is an example of a business that has grown, created jobs, supported the development of many critical breakthrough drugs, paid taxes, and invested in facilities, plants and equipment. We are also an example of how tax law can help create jobs and investments. All of our initial capital came from partnership investors who were seeking opportunities for capital appreciation as well as passive income to offset passive losses, which cannot otherwise provide tax benefits to taxpayers.

Intergen is a unique biotechnology company. We already manufacture and market products and services and we already generate profits. Our company is in business to support the research and development and the manufacturing of biopharmaceuticals, diagnostics, and vaccines. Our products are primarily biological proteins which are used in innovative research throughout the world and are found in new breakthrough therapies and detection systems for cancer, heart disease, hemophilia, hepatitis and other important disease areas. We are also a contract manufacturer of pharmaceuticals produced from biological sources.

Our manufacturing involves very sophisticated and expensive technology to ensure the absolute purity of the proteins we manufacture. Only fifteen years ago the manufactur of many of these proteins was not feasible. We didn't know that many of them existed, and when we did we were not sure whether they could be used to detect or treat diseases.

Intergen began in December 1987 with only eight employees through the acquisition of a small biochemical process business, the Armour Biochemical Company. Today, we support more than 150 jobs in three states with five manufacturing and distribution facilities, three offices in Europe, and a partnership in Japan.

Intergen is a growth company. Our future, however, depends to a large extent on a economic health biotechnology industry, the available of risk capital, and continuation of innovative research. We are an example of how tax policy can influence investment resulting in job creation, tax revenues, and the development of important products that benefit society.

Capital Formation is the Issue

The issue for entrepreneurs in the biotechnology industry is capital formation. Bringing a biotech drug product to the market today is both a lengthy and expensive process. From the initial testing of the drug to final approval from the Food and Drug Administration can take 10-12 years, and this process can cost anywhere from $150 to $359 million. Both the length and cost of this process are a tremendous impediment for small biotechnology companies to be successful bringing a product to the market.

After raising enormous amounts of capital, and conducting cutting-edge research, a company can find that its lead product is not approved by the Food and Drug Administration. We work in an industry which cannot sell and market its products without government approval and the requirements for approval are onerous.

The biotechnology industry consists of over 1,300 companies, of which 265 are publicly traded. The biotechnology industry is one of the most capital intensive industries in the history of civilian manufacturing. R&D accounted for 43% of total costs and expenses incurred by public biotechnology companies in 1994 and expenditures averaged $68,000 per employee. This compares with expenditures of $7,500 per employee for all manufacturing companies.

Total sales for the biotech industry were $7.7 billion in 1994. However, since the industry spends such a large percentage of it's capital on research and development, the industry experienced a net loss of $4.1 billion in 1994, and has lost approximately $14 billion over the last 5 years.

The industry is in-the-middle of one of the worst financial crisis in its history. A major contributing factor to this crisis was the Administration's assault on drug prices. The AMEX biotechnology stock index has declined by 50% since January, 1993.

Ernst & Young reports that there are currently only 27 biotechnology therapeutics and vaccines on the market, with 270 in human development, and over 2,000 in early research stages. Forming capital to fund research and coping with an economic crisis in its capital markets are the keys to the ability of the biotechnology industry to maintain its current competitive dominance in world markets.

Tax Code Skewed Against Entrepreneurs

It should not be surprising that the tax code does not recognize the special strengths and needs of the biotechnology industry. The tax code is old and relatively inflexible and it reflects the values of our economy as it was in the past. The problems entrepreneurs have with the tax code is similar to the problems they have with agency regulations. They may be well intentioned, but they do not work in the real world. We urge this Committee to look at the tax code much as are other committees which are developing a regulatory relief program.

The Congress should ensure that our tax code recognizes the needs and reality of today's entrepreneurs. As this testimony will outline, this mostly requires that existing incentives be made permanent and/or restructured -- the targeted capital gains incentive, the R and E Credit, Section 382, and the Orphan Drug Credit. With the exception of enactment of an across-the-board capital gains incentive, all of these proposals are for amendments to current law, not the enactment of new incentives. That is what is needed to ensure that our tax code does not discriminate against or ignore America's most entrepreneurial industry

Let me now outline our four proposals in more detail.

Capital Gains Tax Incentives

BIO supports enactment of both an across-the-board capital gains incentive and a second tier incentive targeted at direct investments in the stock of emerging companies.

Biotechnology companies depend on direct equity investments to fund research. With so few products approved and so little in sales as compared to expenses, equity investments are the principal source of funding for research. Investors are asked to take tremendous risk with these investments; a risk that the firm's science will be successful, that the products will be approved for sale by government regulatory agencies, and that the market sales will produce profits commensurate with the risk. This risk must be sustained over the 5-10 year period which is involved in biopharmaceutical drug development.

Capital gains tax incentives are important in encouraging investors, including venture capital investors, to purchase the stock of biotechnology companies, to put their capital at risk with a long-term, speculative investment. Tax policy is one of the only variables which the government can influence with respect to the risk involved with these investments.

BIO proposes a two tier capital gains incentive. This proposal originated with Senator Robert Packwood who proposed a combined across-the-board capital gains tax cut and targeted venture capital gains incentive during the crucial 1989 capital gains debate in the Senate. The 1989 debate was the critical capital gains debate during the Bush Presidency because this Committee and the House had adopted a capital gains incentive in its version of the Budget Reconciliation bill -- the Jenkins amendment. Senator Packwood sought to include a gains tax reduction in the Senate bill to ensure that a gains incentive would emerge from the conference. The proposal he advanced was a two-tier incentive which BIO here recommends.

The Packwood capital gains proposal included a sliding scale capital gains tax reduction depending on the length of time the capital asset had been held. It proposed that "qualified venture capital stock" held for four or five years receive a gains tax reduction which was roughly twice as great as the incentive for non-venture capital stock.[1] The definition of "venture capital stock" stock in his proposal was based on a capital gains bill proposed by Senator Dale Bumpers and Congressman Bob Matsui, a bill which is discussed below. Senator Packwood said, "The amendment includes an even more favorable capital gains rate for new venture capital investments. Frankly, this is an idea we picked up from Senator Bumpers." (November 14, 1989, Congressional Record) The Packwood two-tier gains proposal was blocked in the Senate and did not become law.

This same venture capital incentive was later endorsed by President Bush during the 1992 Presidential campaign. President Bush had long endorsed an across-the-board gains tax reduction and in a September 23, 1992, announcement he also endorsed the targeted capital gains proposal. (September 23, 1992, White House Small Business Plan).

Governor Clinton and Senator Gore also endorsed a targeted capital gains incentive during their 1992 campaign. (September 30, 1992, Small Business Plan) A reprint from the October 1, 1992 BNA report on the Bush and Clinton endorsements of the targeted capital gains incentive is printed as an appendix to my testimony.

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[1] The exclusion of gains from tax in the Packwood amendment to the reconciliation bill for non-venture capital stock held for four years was set at 20% and for five years was set at 25%. The exclusion for venture capital stock held for four or five years was set at 40%. The exclusion for non-venture capital stock held for six years was set at 30% and for seven years was set at 35%. The exclusion for venture capital stock held for six or seven years was set at 50%.

BIO, and its predecessor organization, the Industrial Biotechnology Association (IBA), have long endorsed an across-the-board reduction in capital gains taxes. With the deadlock in the Congress on an across-the-board capital gains tax rate reduction in 1989, and the failure to include it in the Bush-Congressional budget deal of 1990, a number of trade associations representing high technology firms -- including IBA, the National Federation of Independent Business, National Venture Capital Association, and American Electronics Association -- endorsed a targeted capital gains incentive. They relied, in part, on the endorsement of this concept by Senator Packwood and were encouraged by the endorsement of it by President Bush and the Clinton/Gore campaign.

These associations continued to endorse an across-the-board gains tax reduction, but with that proposal effectively stymied in the Senate, they sought enactment of an incentive which both Republicans and Democrats could support.

The targeted incentive which Senator Packwood, President Bush and the Clinton/Gore Campaign endorsed provided for a 50% reduction in capital gains taxes for direct investments in the stock (stock bought directly from a company, not secondary trading of the stock after it is issued) of a small business (defined as having $100 million or less in aggregate capitalization) if the investment is held for at least five years. The incentive applied to investments by individual and corporate taxpayers and applied only to investments made after the effective date of the law (not to the sale of investments previously acquired).

Unfortunately, after their election President Clinton and Vice President Gore proposed drastic limitations on the targeted capital gains incentive during the Fiscal 1994 budget debate, incentives which effectively gutted the incentive. These limitations included the following six ways:

1. lowering the capitalization limit to $50 million;
2. not indexing this figure for inflation;
3. applying the incentive only to individual taxpayers;
4. limiting the per taxpayer benefits to 10 times the basis of the investment or $10 million (whichever is greater);
5. exempting only half of the excluded gains from the Alternative Minimum Tax (AMT); and
6. substantially modifying the definitions dealing with "working capital" requirements. The reduction in the number of companies which qualify (the capitalization ceiling) is particularly critical to the biotechnology industry, which needs to raise huge amounts of capital to fund research. Corporate taxpayers are major investors in small companies, so it is important to cover them with this incentive. The per taxpayer limits reduces the prospects for an investor generating sufficient gains on one investment to cover losses of capital with many others. The AMT provision is important as the AMT recaptures the gains tax benefits and for many taxpayers cancels out any incentive to make the investments. And, the working capital rules are completely unworkable.

This incentive, with the Clinton-Gore Administration proposed limitations, was included in the 1993 Budget Reconciliation bill and became law. An informal survey of our members finds that this incentive has not been a factor in forming capital for entrepreneurs and emerging companies.

BIO is delighted that the Congress is poised to finally enact an across-the-board capital gains tax reduction for investments in any "capital asset" (many types of investments) if it is held for one or more years. The incentive would apply to the sale of assets acquired prior to the date of enactment of the incentive. The Congress appears ready also to endorse indexing the basis of the capital assets for inflation. BIO strongly supports both of these proposals and urges the Congress to enact them into law.

BIO continues to support a targeted gains incentive which supplements this across-the-board incentive. This targeted incentive would ensure that there exists a distinct and more powerful incentive for high-risk, long-term investments in entrepreneurial firms and emerging companies. We believe there is a bipartisan consensus on the merits in favor of a targeted gains incentive.

The second tier incentive would build on the false-start of the 1993 incentive in the following eight ways:

1. Increase the capitalization ceiling to at least $100 million, or eliminate it altogether, and index any capitalization ceiling for inflation
2. Apply incentive to corporate taxpayers
3. Provide a gains exclusion which is greater than that which is provided for all other capital assets (e.g. if regular capital gains exclusion is 50%, exclusion for targeted incentive should be 75% or 100%)
4. Eliminate the "10 times or $10 million" per taxpayer limitation
5. Exempt all of the excluded gains from the alternative minimum tax
6. Fix the "working capital" rules
7. Provide for a deferral of gains taxes (a rollover provision) for those who reinvest proceeds from sale of any capital asset into stock covered by this incentive (set time period in which rollover must occur) and
8. Apply the incentive to investments which were made before effective date for 1993 law.

BIO endorses this targeted capital gains incentive as a second tier incentive to be adopted in combination with an across-the-board incentive. The targeted incentive would ensure that the tax code acknowledges the exceptional risk which is involved with investments in biotechnology and other emerging industries. BIO does not propose this incentive as a substitute for the Contract for America across-the-board incentive, which it strongly supports, and would oppose it if it is deemed inconsistent with adoption of the across-the-board incentive.

<u>Research and Experimentation Credit</u>

It is critical that the Research and Experimentation Credit (R and E Credit) be made permanent or extended for 18 months from the date it scheduled to expire, June 30, 1995. This extension would have the Credit expire on December 31, 1996. In addition, BIO supports restructuring the R and E Credit by reducing the fixed base limitation from 16% to 8% and raising or eliminating 50% cap.

If the Credit is extended and not made permanent, the Congress should at least ensure that most biotechnology companies qualify for the credit; due to the peculiar structure of the credit many biotech companies do not now qualify for it. There is something fundamentally wrong with an R and E Credit if biotech companies, with their intensity of research, cannot claim it.

The restructuring which we propose would lower the fixed-base percentage limitation from 16% to 8%. The 16% maximum base percentage is the limitation on qualified research (as a percentage of sales) which may be used to calculate the R and E Credit. Many biotech companies' research and development-to-sales ratio exceeds 16% in their early years. In short, the 16% is far too high.

As biotech companies mature and begin to generate sales, their research-to-sales ratio begins to move closer to the average for pharmaceutical companies, about 15%. This pharmaceutical average ratio is itself three times higher than the all industry average, so you can see how high the ratio is for biotech companies.

The problems with the 16% fixed base limitation is compounded by the fact that roughly 50% of a biotech company's financial statement R and D expenses do not quality for the R and E Credit. Overhead and other costs of R and D do not qualify for the R and E Credit. A 16% limitation, therefore, requires a biotechnology company to invest over 32% of its sales in R and D (per its financial statement) to get any R and E Credit. This is clearly too high. The practical effect is that the most biotech companies will never receive an R and E Credit until they are mature, even if they invest far more revenue in R and D than any other type of company.

To correct the inequity of the current law, the 16% fixed base limitation should be reduced to 8%. This will still require biotech companies to spend at least 16% of sales on R and D in order to qualify for the R and E Credit.

In addition the 50% cap on R and E Credits should be eliminated. It makes no sense that biotech companies which finally do qualify for the R and E Credit should be hit with a 50% maximum credit.

<u>Orphan Drug Credit</u>

BIO supports making the Orphan Drug credit permanent or extending it for 24 months until December 31, 1996, the same minimum extension we recommend for the R and E Credit. As I will explain the R and E and Orphan Drug Credits are closely related and should be considered in tandem. BIO also supports restructuring the Orphan Drug Credit so that it can be carried forward by companies with no tax liability with respect to which to claim the credit. Most biotech companies have no sales and, therefore, no tax liability, so a credit which cannot be carried forward is of no value to them as an incentive for research on orphan diseases. We also recommend that pre-clinical trial expenses be covered by the Credit and that taxpayers paying the alternative minimum tax be permitted to reduce this tax by the amount of their Orphan Drug Tax Credits.

If the Orphan Drug Credit is extended and not made permanent, the Congress should at least ensure that the credit is restructured. As with the R and E Credit, there is something fundamentally wrong with an Orphan Drug Credit if biotech companies, with their intensity of research on orphan diseases, cannot use it.

An orphan disease is statutorily defined as one that afflicts fewer than 200,000 people in the United States. As many as 20 million Americans suffer from one of about 5,000 rare diseases. Diseases falling into this category include cystic fibrosis, hepatitis B, multiple sclerosis, renal cell carcinoma and pituitary dwarfism. An "orphan drug" is a drug or biological product designated for treatment of a rare disease.

The U.S. biotechnology industry is a leader in the development of drugs to treat rare diseases, many of which are life threatening and seriously debilitating. The unique scientific methods of biotechnology -- which focus on the genetic and molecular bases of disease -- make biotechnology companies especially capable of developing safe and effective treatments for rare genetic and metabolic disorders.

This cost, risk and delay is the most powerful argument in favor of a permanent credit. When the Bush Administration proposed in 1992 that the Credit be made permanent, it stated, "Clinical testing is long-term in nature, and taxpayers should be able to plan their activities knowing that the credit will be available when the clinical testing is actually undertaken. Thus, if the orphan drug credit is to have its intended incentive effect, it should be made permanent."

The Orphan Drug Tax Credit is an alternative to the Research and Experimentation Credit (R and E). The Orphan Drug Credit focuses on clinical trial expenses for orphan drugs and the R and E Credit focuses on all research expenditures. Firms with research which qualifies for the Orphan Drug Credit do not claim the R and E Credit for the same expenditure. The Orphan Drug Credit is 50% and the R and E credit is only 20%.

Unfortunately the Orphan Drug Credit is not helpful to many biotechnology companies because, if it can only be used in the tax year in which the research expenditures are made, it cannot be carried forward for 15 years, as is the case with other business tax credits. Most biotechnology companies do not, in fact, have tax liability with respect to which the credit may be taken, so they reap no value from the Credit. Permitting 15 year carryforwards, which is the norm for other business credits, would ensure that all biotech companies, including those with no current tax liability, are given an incentive to conduct research on orphan diseases. This would permit companies whose first product is an orphan drug to carryforward their credits until they begin to generate revenue based on sales of that first product.

Only clinical trial expenditures are covered, not pre-clinical trial expenses. Pre-clinical trial expenses for research on cures and therapies for orphan diseases can be substantial and should be covered.

Finally, current law provides that the alternative minimum tax (AMT) is not reduced by any credits except the AMT foreign tax credit. A company incurring tax under the AMT and earning Orphan Drug Credits can not receive any benefit from the credit. This puts companies paying the AMT at a disadvantage vis-a-vie companies paying the regular tax. Companies should be permitted to reduce their AMT payments by the amount of their Orphan Drug Credit.

The last extension of the Credit was in the 1993 Budget Reconciliation Act. The Joint Committee on Taxation estimated that the limited 1993 extension of the credit would cost $18 million during Fiscal Years 1994-1998. We do not yet have an estimate for our proposals to restructure the Credit.

<u>Conclusion</u>

The biotechnology industry is a major success story in the making in America. It is the more entrepreneurial industry in terms of research intensity and capital formation. It thrives on innovation and long term risk-taking. We should ensure that our tax code recognizes its unique characteristics and needs.

Thank you for the opportunity to testify here today.

Mr. ZIMMER. Thank you, Mr. Beckman.

Next, we will hear from Dr. Norman Ture, president of the Institute for Research on the Economics of Taxation.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. TURE. Thank you, Mr. Chairman.

I ask to have my full statement included in the record, and I will provide a brief summary. Let me say, the remarks I am about to offer are my own, not necessarily shared by the board of directors or other staff of the Institute.

The reduction in capital gains tax rates and the inflation adjustment of the bases of capital assets proposed in title I of H.R. 9 would contribute significantly to moderating the bias against savings imposed by the existing Federal tax system. In view of the projected preemption of virtually all of the Nation's saving by Federal entitlement spending, easing the antisaving tax bias is of the utmost urgency and should command top tax policy priority.

The existing tax treatment of capital gains increases the cost of saving compared to consumption uses of current income. This antisaving impact is exacerbated by taxing nominal rather than inflation-adjusted gains. Moreover, taxing realized gains, particularly without inflation adjustment, immobilizes accumulated saving and impairs the capital market's critically important function of assigning savings to their most productive uses.

The proposed deduction from adjusted gross income of 50 percent of net long-term capital gains and inflation adjustment of basis would significantly improve the tax treatment of capital gains. These revisions would materially reduce the income tax bias against all saving, not merely that invested in property identified as capital assets.

Both business and household saving are likely to increase substantially above levels that would otherwise occur, although the desirability of the proposed capital gains reform does not depend, in my judgment, on how large the saving response will be.

Both of these proposed reforms would also contribute significantly to reducing tax impediments to investors changing the composition of their asset holdings in response to market signals and would improve the efficiency of the market's performance.

The committee should recognize that reducing the capital gains tax will increase the differential between the tax burden on distributed and retained corporate earnings. Enactment of title I will increase the desirability of providing some relief at the corporate level for dividend distributions.

The revenue effects of the proposed capital gains reform should be defined as the difference in revenues realized in any given period of time with and without the proposed reforms. They should not be defined as the difference in revenues realized in any one year compared to the prior year.

Estimates of the revenue effects of title 1 should take account of the resulting changes in the market value of existing capital assets and the increased saving and economic activity and the tax revenues generated thereby that would occur, not merely the increase in gain realizations.

More severely taxing saving and consumption uses of income is grossly unfair as well as economically damaging. Title I of H.R. 9 is a welcome initiative for addressing this unfairness.

Thank you.

[The prepared statement follows:]

CAPITAL GAINS REFORM, TITLE I OF H.R. 9, THE JOB CREATION AND WAGE ENHANCEMENT ACT OF THE CONTRACT WITH AMERICA

STATEMENT OF NORMAN B. TURE, PRESIDENT
INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION (IRET)
PRESENTED TO
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 25, 1995

Mr. Chairman, members of the Committee, I appreciate the opportunity to discuss with you the significant improvement in the federal income tax that will be provided by enactment of Title I of H.R. 9. Both of the principal features of the proposed capital gains reform — the reduction in the marginal tax rates applicable to capital gains and the inflation adjustment of basis — are highly commendable as well as long sought. For those of us who have over the past thirty-five years devoted their efforts to calling tax policy makers' attention to the severe anti-saving, anti-investment bias in the income tax and to the seriously adverse economic consequences of that bias, Title I is a constructive and encouraging initiative. Its enactment would, itself, contribute to moderating that unwholesome tax bias and would afford promise of additional efforts to eliminate it completely.

The urgency of reducing, if not entirely eliminating, the income tax's anti-saving bias was highlighted last year by the findings of the Bipartisan Commission on Entitlement and Tax Reform. As you know, the Commission found that projected spending under existing federal entitlement programs would exceed the entire amount of revenues projected to be provided under existing tax laws by about the year 2025. The resulting deficit would preempt all of the saving undertaken by American households and businesses, leaving no saving for investment in private capital formation and other growth-generating private uses. Moreover, in those budget circumstances, the American economy could not rely on foreign saving to finance the additions to the stock of capital needed to maintain, let alone advance, labor's productivity and the nation's real living standards.

Even if one discounts the Commission's projections to a substantial degree, an economic holocaust is looming. The economy is accelerating down a slippery slope that ends at the edge of a cliff. The longer the delay in addressing the growth in entitlement spending and in removing tax barriers to household and business saving, the more difficult it will be to apply the brakes before we go over the edge.

In view of the obvious disinclination to deal constructively with entitlement spending, particularly the Social Security and Medicare Systems, the need to reduce the tax bias against saving is all the more demanding of the Congress's attention. This Committee is to be commended for having begun the work of seeking out and remedying the provisions of the Internal Revenue Code that produce that bias. Title I of H.R. 9 is an important step in that effort.

The Anti-Saving Tax Bias

The anti-saving, anti-investment bias in the income tax results from the fact that both income that is saved and the income produced by investing that saving are subject to tax, often several times over, while income that is used for current consumption is taxed only once. The consequence is that the amount of current consumption that must be forgone to obtain any given amount of after-tax return on one's saving is greater than if either the income that is saved or the return it produces were excluded from the tax base. The forgone consumption is, of course, the real cost of obtaining that future income. In other words the income tax increases the cost of saving compared to the cost of current consumption. Moreover, the income-tax induced increase in the relative cost of saving is greater the higher is the tax rate to which the person is subject.

The appendix to my statement provides a number of simple arithmetic examples that show how the individual and corporate income taxes and the taxation of capital gains raise the cost of saving relative to consumption uses of income.

The anti-saving bias is accentuated by the separate income taxation of corporate income. The appendix includes an illustration of the additional increase in the relative cost of saving imposed by the separate income taxation of income generated by corporate businesses.

The taxation of capital gains also contributes to raising the cost of saving relative to the cost of current consumption. If instead of distributing its after tax earnings, the corporation retains and reinvests them in assets yielding at least the same rate of return that was obtained before, the market value of the corporation's stock is likely to increase by the amount of the retained earnings per share. If the person decides subsequently to sell the shares, the excess of the sales proceeds over the person's investment — the realized capital gain — is subject to the individual income tax. Because the capital gains tax is deferred until the accumulated after-tax corporate earnings are realized by the sale of the shares, the present value of the capital gains tax is less than the present value of the taxes paid on distributed corporate earnings over the period the shares are held. Notwithstanding, the capital gains tax adds to the amount of current consumption that must be given up per dollar of after-tax returns on one's saving. An example in the appendix illustrates the effect of the capital gains tax on the cost of saving.

The anti-saving, anti-investment bias of the income tax system is further accentuated by the federal transfer (estate and gift) taxes, by State income taxes, by State and local property taxes and by numerous selective taxes on capital or the returns capital produces imposed by State and local governments.

Moreover, the anti-saving bias is exacerbated by the imposition of the tax on the nominal rather than on the inflation-adjusted returns on saving and investment. The expectation of inflation, *per se*, adversely affects saving and investment. Inflation expectations increase the rate at which the returns on saving must be discounted to determine their amount in real terms; unless the expected returns increase at least as rapidly as the expected inflation rate, the value of the expected *real* returns will be depressed, thereby increasing the cost — the forgone current consumption — of any given amount of real future income.

Taxing nominal capital gains aggravates this effect of inflation in increasing the cost of saving. This effect is likely to be particularly severe in the case of gains realized on the sale of corporate stock the market value of which has not kept pace with inflation. It may well result in taxing real losses, not merely overtaxing real gains that are less than nominal gains.

Taxing realized capital gains also impedes transaction in capital assets. An investor will be reluctant to sell his or her capital assets in order to purchase other assets unless the present value of the expected net returns on the replacement assets exceeds that of the expected returns on the existing holding by enough to defray the tax on any gain realized on the sale of the latter. For any given amount of accrued gain, the higher is the capital gains tax rate, the more imposing is the tax barrier to such changes in the composition of a person's assets.

This locking-in effect of the tax on capital gains impedes the assignment of accumulated savings to their most productive uses. As a result, it impairs the essential function of the capital market — to facilitate the exchange of property rights. This tax-induced barrier to these exchanges distorts the market's function in assigning values to competing uses of saving. The effectiveness with which this function is performed has a critically important bearing on how efficiently our saving is assigned to competing businesses and their use of our saving in expanding production- and income-generating capacity. Misusing our saving — directing it into companies and capital uses that are less productive than alternatives — is just as wasteful and costly as misallocating any other production inputs. To the extent that taxing capital gains locks in holdings of capital assets, it impairs the capital market's functioning and contributes to less than optimum uses of our saving and capital formation.

Benefits From Enactment Of Title I

Both the proposed deduction from adjusted gross income of 50 percent of net long-term capital gains and the adjustment for inflation of the basis of capital assets would be significant improvements over the existing law treatment of capital gains. Of these provisions, the 50 percent exclusion is likely to be more significant in improving the tax climate for saving and investment.

Section 1001. 50 Percent Capital Gains Deduction

The proposed deduction from adjusted gross income of half of net long-term capital gains has the effect of cutting the marginal tax rates in half for individual taxpayers in the 15 percent and 28 percent brackets and of affording smaller, but still significant percentage reductions in the capital gains tax rates for people in higher brackets. For corporations, the proposed deduction would cut the top effective marginal rate on capital gains to 17.5 percent from 35 percent. These rate reductions would mitigate the adverse effects, discussed above, of the existing tax treatment.

Reducing the tax bias against saving

The fundamental economic benefit that would be realized from enactment of Title I would be the reduction in the severe bias against saving imposed by the existing federal tax system, particularly the personal and corporate income taxes. As the discussion above shows, even outright elimination of the capital gains tax would not fully rid the tax system of its anti-saving, anti-investment bias. There should be no doubt in the Committee members' minds, however, that the proposed 50 percent gain deduction would make an important contribution in moving the tax system in the direction of neutrality between saving and consumption uses of income. It would, in other words, significantly reduce the extra cost of saving relative to consumption.

This highly desirable effect on the cost of saving would not be confined, it must be stressed, to saving invested in capital assets, as defined in the Internal Revenue Code. In an efficiently operating capital market, changes in market valuations in response to tax changes impel reallocations of saving until risk-adjusted net-of-tax returns are substantially equalized among all assets. Reducing the marginal tax rate on capital gains will reduce the cost of saving invested not only in capital assets but in all other uses, as well.

The desirability of the 50 percent deduction and consequent reduction in marginal tax rates on capital gains does *not* depend on how large the saving response to the overall lower cost of saving will be. The objective of this reform is to reduce the existing anti-saving tax bias, not to dictate to households or businesses what uses they make of their income claims and property rights. Reducing capital gains taxes is constructive tax policy whether the resulting increase in saving is great or small.

Having said this, I believe that reducing taxes on capital gains will indeed result in significantly more saving than would otherwise be undertaken. Sound economic analysis urges that tax changes that reduce the cost of saving relative to consumption uses of income will lead to higher levels of saving than would otherwise occur. Opponents of capital gains tax reform insist that saving is little if any responsive to changes in its cost. They obviously fail to note that in making that assertion they are also maintaining that consumption is little if any responsive to changes in its cost. In other words, according to these folks, people and businesses pay no attention to taxes in deciding anything about their economic activities. The Committee should recognize in this viewpoint a license for imposing any amount of any kind of taxes without regard for the damage that will result.

Improving capital market efficiency

Reducing the marginal rate of tax on capital gains will also ease the lock-in effect described above. It will, therefore, reduce the existing tax impairment of the market's function in facilitating the exchange of property rights, hence the market's efficiency. This enhancement of market efficiency is a very important benefit to be obtained from the proposed reduction in marginal tax rates on capital gains, irrespective of the magnitude of the change in the amount of gains realized.

Section 1002. Indexing The Bases Of Capital Assets For Purposes Of Determining Gain Or Loss

Adjusting the basis of assets for purposes of determining gain or loss upon the disposition of the assets would avert accentuating the income tax's anti-saving bias in an inflationary environment. Clearly, this proposed change in the tax treatment of capital gains and losses would be inconsequential in an economic setting in which savers were absolutely confident that no inflation would occur over the time period that is relevant for their saving-investment decisions. By the same token, it would afford greater benefits the higher is the expected rate of inflation. Even if the expected inflation rate is quite modest, however, adjusting asset bases for inflation will forestall the adverse effect of the risk of inflation on saving and investment, discussed earlier in this testimony.

Indexing the bases of capital assets for inflation will also contribute, clearly, to freeing up currently locked-in savings. It will, therefore, make an important contribution to enhancing the efficiency with which the capital market performs its functions.

The Committee has heard testimony from the Treasury Department to the effect that in combination with the 50 percent deduction, adjusting the basis of capital assets for inflation "...provides too large an adjustment for inflation."[1] In making this assertion, Assistant Treasury Secretary Samuels erroneously identifies the proposed deduction of 50 percent of net long-term capital gains as aimed at offsetting inflation, suggesting that there would be no occasion for this change in the absence of inflation. In fact, as discussed above, the 50 percent deduction aims at partially offsetting the incremental tax penalty on saving, irrespective of expected inflation. By the same token, the proposed indexing aims at offsetting the additional tax penalty imposed by taxing nominal rather than real gains. In combination these two provisions can, contrary to Secretary Samuels' assertion, provide too large an adjustment *only* if one believes that good tax policy calls for penalizing saving uses of current income relative to consumption uses and for taxing more gains than people actually realize.

The Treasury testimony also asserts that indexing the basis of capital assets without indexing the debt used to finance the acquisition of the assets would encourage tax arbitrage and enable taxpayers to reduce their effective tax rates to zero. Mr. Samuels' example is a person who purchases $100,000 of undeveloped land, financing the purchase with $20,000 of his or her own cash and borrowing $80,000. The person later sells the land for $130,000, "with the $30,000 gain representing an inflationary increase in the value of the property." The person repays the $80,000 mortgage debt and pockets the remaining $50,000, paying no tax because the basis of the asset was indexed. According to Samuels, "...only $6,000 ...of the taxpayer's total $30,000 gain...represents the inflationary gain on the taxpayer's $20,000 investment...."[2] Presumably, according to Samuels, the correct result in principle would be to tax the person on the remaining $24,000 of *nominal* gain.

Notice, however, that in terms of constant purchasing-power dollars, the $50,000 in cash the person has left after paying off the mortgage indebtedness is only $20,000, exactly the amount of the person's original *cash* investment. If the person were subject to tax on the $24,000 of gain allocated by Samuels to the mortgage component of the investment, as Samuels suggests, the person would net only $17,280. The tax would subject the person to a net loss of $6,720 on the original investment. In fact, the arbitraging that Samuels asserts would result from indexing the basis of the asset but not the debt protects the person from having to pay tax on a zero gain. The Treasury's complaint is without merit.

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[1] Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy) before the Committee on Ways and Means, January 10, 1995, page 16.

[2] The person's investment, contrary to Samuels' assertion, is $100,000, not $20,000. The person has undertaken an indebtedness for the discharge of which the person is legally responsible.

There is much to commend extending inflation adjustments to indebtedness and the interest flows thereupon. There is, however, no downside of the sort the Treasury has asserted to indexing capital assets alone.

This is not to say that the indexing proposal is free of problems. For one thing, in the case of financial assets such as corporate common stocks, the proposed basis adjustment would apply as a rule only to the initial investment. The proposed indexing would not apply to the additions to basis represented by the corporation's retaining and reinvesting some of its after-tax earnings. The proposed indexing, accordingly, would apply to a smaller and smaller share of the accumulating basis of the stock the longer the stock is held, leaving larger and larger amounts of nominal gains exposed ultimately to tax. I urge the Committee to address this deficiency, and I'll be happy to provide the Committee and its staff such assistance as it may request in doing so.

I also urge the Committee to extend indexing of basis for the purpose of determining gain or loss on the disposition of equipment subject to a net lease when the proposed neutral cost recovery system is not used. The differences in contractual arrangements for the acquisition and use of property in a trade or business should not enter into determination of the eligibility of property for the inflation adjustment of basis. Even under modest inflationary expectations, denying this basis adjustment to property subject to a net lease would expose lease arrangements to a significant market place disadvantage with no discernible gain concerning tax principles.

<u>Dividend Tax Relief</u>

Desirable as I believe to be the capital gains tax reforms the Committee is considering, the Committee should be aware that their enactment will tend to bias corporate decisions in favor of retaining after-tax earnings rather than distributing them as dividends to shareholders. As noted earlier in this discussion, the fact that the tax on capital gains is deferred until the gains are realized somewhat abates the punitive effect of taxing income generated by corporate businesses both to corporations and their shareholders. There can be little doubt that this somewhat influences corporate distribution policies, although the magnitude of this influence is by no means certain.[3] Expanding the differential in effective tax burdens on retained vs. distributed earnings by reducing capital gains taxation should urge the Committee to add to its agenda careful consideration of ways to integrate the income taxation of corporations and their individual owners. An initial step in this direction would be to provide some relief at the corporate level for dividend distributions.

<u>Revenue Effects</u>

At one time or another, the case for reducing the marginal tax rates on capital gains and for inflation indexing of the bases of capital assets has rested on the claim that either or both of these reforms be tax revenue raisers. As the Committee might well infer from my discussion to this point, I believe the case for these reforms rests on the very substantial economic benefits that would be obtained, not on their revenue consequences. I believe that enactment of Sections 1001 and 1002 of Title I of H.R. 9 would very likely prove to be a revenue raiser, but I strongly endorse these reforms notwithstanding.

Much of the arguments among economists and other tax specialists about the revenue effects of these changes in the tax treatment of capital gains has hinged on estimates of the magnitude of the unlocking effects of these changes. Most of the empirical analyses that have been directed to this question have relied on time series of changes in capital gain realizations to measure the response to changes in the tax treatment of these gains. But an enormous number of other variables also affect the amount of capital asset transactions and the amount of gains realized thereby every year. Making allowances for these myriad other factors in efforts to

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[3] In the last decade and a half, an important academic literature has been produced that strongly suggests that some of the serious problems of corporate governance noted during the 1980s are attributable to corporate executives' efforts to maximize their welfare at the expense of maximizing the net worth of corporate owners. Excessive retention of corporate earnings may have contributed to these problems.

determine the influence of changes in the tax law in such year-over-year analyses is a daunting undertaking. The Committee should not base its decisions about capital gains reforms solely or even primarily on such revenue estimates.

The conceptually correct measure of the effect of the change in the law is the difference between the amount of gains actually realized in any particular time period and the amount that *would have been realized* in the absence of the change in the law. This, too, is difficult to estimate, but it at least aims at providing a relevant answer to the question.

For the most part, the revenue estimates have been driven only by estimating the increase in capital gain realizations resulting from reducing the capital gains tax; they have ignored the virtually instantaneous increase in the market value of existing capital assets that would result from reducing the tax. This valuation effect would augment the amount of gain realized on the sale of any given amount of capital assets. To be sure, this valuation effect is one shot; because it would result in higher bases of capital assets in the hands of those purchasing the unlocked assets, it would tend to reduce the amount of taxable gains realized thereafter. Nevertheless, this valuation effect will tend to increase revenues, on balance, and should not be ignored in estimating the revenue consequences of reducing the marginal tax rates on realized capital gains.

Also ignored in most of the revenue estimates are the broader, very likely most consequential economic effects resulting from reducing the marginal tax rates on capital gains — the resulting increase in saving. The consequent increase in the stock of capital would itself generate additional taxable income; additionally, the increase in capital would contribute to an increase in labor's productivity, hence to employment and wages, leading to additional tax revenues from income, payroll, and other federal taxes.

"Fairness"

Finally, a word about the "fairness" issue. Congressional consideration of tax proposals aimed at reducing tax barriers to saving, capital formation, and entrepreneurship has far too often been blocked by redistributionist assertions that such proposals are unfair because they would benefit rich people and/or business. It is well past time for policy makers to recognize that the goodness or badness of a policy does not depend on the specific attributes of the people who are immediately affected by them. A tax change that reduces the existing tax penalty on saving compared with consumption uses of income is not unfair because it may well more substantially reduce the tax liabilities of people who pay a great deal of taxes and who will greatly increase their saving in response to the tax change than it will the taxes of people who pay little or no taxes.

There is no meaningful social, let alone economic policy goal that is served by punitively taxing saving; such punitive taxation is not made "fair" because its weight is greater on the rich or on business than on others. And when one considers that the principal beneficiaries of increases in saving, capital formation, entrepreneurship, and other growth generating activities are labor and consumers, redistributionist objections to easing the differentially heavier tax burdens on these various activities should be dismissed out of hand.

Addressing the unfairness in more heavily taxing income that is saved than income used for current consumption promises substantial dividends in higher standards of living for everyone. Title I of H.R. 9 is an effective beginning.

APPENDIX

Basic Income Tax Bias Against Saving

Pretend, for a moment, a no-tax world in which someone earns an extra $1,000. The person can either use the $1,000 for additional consumption or to purchase a perpetuity — a bond with no maturity date — paying, say, 10 percent a year. The person's choice is to enjoy $1,000 of additional consumption now or to have an additional $100 of income every year. The cost of each dollar of the additional income — the forgone consumption — is $10.

Now assume an income tax of the same basic configuration as the existing income tax is levied at a rate of, say, 25 percent. On the additional $1,000 of current income there is a tax of $250, leaving the person with $750 after tax that can be used either to buy an additional $750 of current consumables or a $750 bond paying 10 percent a year. Of course, the $75 of interest on the bond is also subject to the income tax, so that the after-tax income on the saving is $56.25. The person's choice is $750 more of current consumption or $56.25 more income each year. The cost — the forgone consumption — per dollar of that additional interest income is $13.33. The income tax increased the cost of obtaining future income compared to the cost of current consumption by 33.33 percent.

As noted in the text, this tax-induced increase in the cost of saving compared to that of current consumption is greater the higher is the marginal tax rate to which the person is subject. Suppose the tax rate to be paid by the person in the example were 40 percent instead of 25 percent. In this case, the income tax would increase the cost per dollar of additional future income from $10 to $16.67 or by 66 2/3 percent.

Additional bias imposed by the corporate income tax

Suppose that instead of buying a bond, the person in the example were to invest the additional income in corporate stock, and suppose the earnings per share were also 10 percent of the investment. Suppose the corporate tax rate were 35 percent and that the corporation were to distribute all of its after-tax earnings. In this case, the 25 percent bracket taxpayer would net $36.56 each year ($75 gross return on the $750 corporate investment, reduced by the 35 percent corporate income tax and the 25 percent individual income tax), for which he or she would have to forgo $750 of current consumption; the combined corporate and individual taxes raises this person's cost per dollar of additional future income from $10 to $20.51, a little more than 100 percent. If the person were in the 40 percent bracket, each net-of-tax dollar of return on his or her investment would cost $25.64 of forgone consumption, more than 150 percent more than in the absence of taxes.

The capital gains tax bias against saving

Suppose that the corporation retains its after-tax earnings and reinvests them in assets producing the same rate of return as before. Also suppose the 25 percent tax bracket person in our example held the stock for, say, five years before selling it. By assumption, the value of the stock will have increased from $750 to $1,027.57. On the gain of $277.57 realized on the person's sale of the stock, he or she owes $69.39, leaving an after-tax gain of $208.18. The same result would be obtained if the person were to receive an after-tax annuity of $43.48 over the five year period. With this tax treatment, the cost per dollar of future income, in terms of forgone current consumption, is $17.25 [4] Although the deferral of tax until the capital gain is realized imposes less of a tax penalty on saving than in the former case, it nevertheless substantially raises the cost of obtaining future income, in this example by 72.5 percent, compared to the cost in a no-tax world.

Section 1001 of H.R. 9 would significantly reduce the cost of saving compared with present law. If the person in the example were required to include only half of the net long-term gain in taxable income, the capital gains tax due upon the sale of the stock at the end of five years would be $34.70, leaving a net gain of $242.87. The same result would be obtained had the person received an after-tax annuity over the five years. In this case, the cost per dollar of future income would be $15.25 or 52.5 percent more than in a no-tax world but significantly less than under the existing tax treatment.

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[4] The cost of future income, in these terms, would be lower the longer the person deferred realization of the capital gain.

Mr. ZIMMER. Thank you.

Our final witness is Robert McIntyre, director of Citizens for Tax Justice.

STATEMENT OF ROBERT S. MCINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. MCINTYRE. Thank you, Mr. Chairman.

I want to congratulate the new members of the committee. I have been following this committee for the last 20 years, and there are a lot of new faces here. I especially want to congratulate the new chairman, Mr. Archer. So if you would pass that on I would appreciate it.

I am before you today not as a supplicant as so many of the other witnesses seem to be. We have heard from a lot of people who are doing well in their businesses. Indeed, they are bragging about it. But in the same breath, they say they would like you to give them a pass on some of the taxes they currently have to pay. In my view, they ought to be ashamed of themselves.

Last Saturday, the Washington Post reported that Chairman Archer had told the staff of the committee to be on the lookout for any provisions in the Tax Code that aren't in the taxpayers' best interest. I was kind of cheered up by that—until I thought about the Contract. I said to myself, wait a minute. If he finds such bad provisions, he will probably double them.

Because it seems to me that the Contract, with its $100 billion a year in new tax breaks, has found the two biggest high-income and corporate breaks in the Tax Code and has proposed to double them. Those are capital gains tax breaks and corporate depreciation tax breaks.

My written testimony discusses both these issues. I will focus in my oral statement today on capital gains.

If these proposed changes are adopted, they will not only undermine tax fairness but they will also undermine the economic neutrality that we gained in the 1986 Tax Reform Act. They will put Congress and this committee back in the position of directing the allocation of private investment rather than leaving it where it belongs, which is in the hands of businesses and consumers.

We will once again face rampant tax sheltering and outrageous high-income and corporate tax dodging. And, ultimately, the price for it all will be paid by average American families through higher interest rates, reduced government services and eventually, I think, higher taxes.

So we urge the committee to reject these kinds of tax reforms and instead work to close down some of the remaining wasteful, economically harmful subsidies in the Tax Code that benefit the few at the expense of everyone else.

Now you may remember that to his great credit President Ronald Reagan was able to overcome his initial proclivity for tax subsidies. He noticed that the loophole-based policies of the early eighties hadn't worked. They had given us lots of unneeded office buildings. They had given us lots of other wasteful misallocations of our American capital effort, but they hadn't succeeded at all in increasing savings or investment.

And as a result, President Reagan reversed himself, and his leadership was critical to the enactment of the 1986 Tax Reform Act, which closed down those loopholes.

So it was very distressing, to me at least, to see a new Republican Congress, which talks about ending waste and defending the middle class and curbing unwarranted government interference in the free market, proposing vast new tax-based subsidies that look to me a lot more like central planning than any faith in market forces.

Even under current law, capital gains are treated much more favorably than other types of income, especially for the highest income people. Capital gains are not taxed at all until they are realized, generally on sale. Even when they are realized, there is the equivalent of a 30-percent exclusion for top-bracket people. In total, the current capital gains breaks now on the books are estimated to cost about $170 billion over the next 5 years.

Almost two-thirds of the total capital gains reported, by the way, go to people with incomes over $200,000. Only about 7½ percent go to people with incomes under $50,000. Thus, more than any other type of income, capital gains are concentrated at the very top of the income scale.

Now, the Republican Contract With America talks about increasing that capital gains differential tremendously. When you add up indexing plus the 50-percent exclusion, it amounts on average to about a two-thirds exclusion for capital gains. Treasury thinks that will cost about $183 billion over the next 10 years, most of it in the second 5.

That works out on a full-year basis to about $50 apiece for a middle-income family and about $16,000 apiece for the top 1 percent in total capital gains breaks if the proposal is adopted. And, of course, the proposal would also apply to timber and coal and iron ore and a few other specially favored industries who, for historical and accidental reasons, get to treat part of their profits as capital gains. Those companies, as we know from the late seventies and early eighties, could go back to paying little or nothing in Federal income tax.

The case for a capital gains cut, which you have heard over and over again here today, is that somehow it will lead to more jobs, more investment, and more economic growth. You would think we might have learned something from the past. Because we have tried capital gains tax cuts and capital gains tax increases several times over the last couple of decades, and the funny thing is that every time the tax was cut, the economy took a nosedive. Jobs went down and investment declined. And every time the tax was increased, investment did better and jobs did better and the economy did better.

So do capital gains tax cuts cause the economy to go into recession? Probably not, but the evidence they don't help the economy seems pretty overwhelming.

Now, the promises people made that cutting the capital gains tax would lead to a short-term boom were silly when they were made. They didn't even match the theory that proponents were offering. But let's look at long-term effects.

The people that are pushing capital gains tax cuts seem to believe, honestly, I guess, that the market doesn't work, that money should go to them rather than to where the market would send it.

Well, I think, and I hope that Republicans think, that the idea that the government should be making investment decisions for business is just terrible economics. The truth of the matter is that paying people or corporations to make investments that otherwise don't make any business sense undermines economic growth. It is the last thing we need.

I hope this committee will focus not on opening up new loopholes and giving new subsidies, but instead on getting the government back to doing what it ought to do, building roads, protecting children and so forth, and not on doing what it does badly, that is trying to run the economy and micromanaging it. We hope you reject these proposals.

Thank you.

[The prepared statement follows:]

Testimony of Robert S. McIntyre
Director, Citizens for Tax Justice
Before the House Ways and Means Committee
Regarding Proposed New Tax Subsidies for Capital Gains and Corporate Profits Designed to Gut the Tax Reform Act of 1986
January 25, 1995

I appreciate the opportunity to testify before the Committee on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

The Republican "Contract with America" proposes an array of new tax breaks whose costs will be close to $100 billion a year once they take full effect. The bulk of these enormous revenue losses stem from two items: huge new tax breaks for capital gains and a major expansion in corporate depreciation write-offs. We strongly oppose these proposals. If enacted, they would undermine the gains in tax fairness and economic neutrality achieved in the 1986 Tax Reform Act. They would once again put Congress in the position of directing and allocating private investment, rather than leaving it where it belongs—in the hands of businesses and consumers. We would once again face rampant tax sheltering and outrageous high-income and corporate tax dodging. Ultimately, the price would be borne by average Americans, through higher interest rates and eventually, increased taxes. We therefore urge the Committee to reject these tax deforms, and instead to work to close remaining wasteful, economically harmful tax subsidies that benefit the few at the expense of most families.

Introduction

At the heart of the GOP Contract appears to be the premise that our current income tax is biased against savings. The drafters of the Contract seems to believe that this alleged bias has caused a lower national savings rate than we otherwise would have. And thus, they conclude, we need to tilt the tax code so that it rewards saving and punishes consumption.

This is an interesting theory, but it hardly squares with reality. The truth is that the current tax code includes huge tax breaks for savings and investment. The loopholes range from no tax at all on some kinds of investment income, to outright "negative" tax rates on the profits from some kinds of corporate investments, to industry-specific tax breaks targeted to the politically powerful. In fact, the $200-billion-plus annual cost of tax expenditures for savings and investment is now almost equal to the total annual amount of personal savings! It seems rather apparent that if our savings rate is too low, tax breaks have been part of the problem, rather than the solution.

Savings and investment tax breaks are not simply a failed experiment in macroeconomic engineering. They also cause significant distortions in business decision making—to the detriment of overall economic growth. Worst of all, most savings and investment loopholes seriously undermine tax fairness, because they are extremely tilted toward the very best-off people in the country. To his great credit, President Ronald Reagan was able to overcome his initial inclination toward favoring loopholes, and his leadership was crucial to enactment of the Tax Reform Act of 1986. Thus it is distressing to see the new Republican Congress—supposedly dedicated to ending waste, defending the middle class and curbing unwarranted government interference in the free market—proposing vast new tax-based subsidies that look much more like central-planning than trust in market forces.

Capital gains

Capital gains are profits reflecting increased values of stocks, bonds, investment real estate and other "capital assets." Under current law, capital gains are treated much more favorably than other types of income, especially for the highest income people. In fact, total current capital gains loopholes are estimated to cost $170 billion over the next five years. In terms of cost and maldistribution—not to mention contentiousness—tax breaks for capital gains are without parallel.

Capital gains are not taxed at all unless and until they are "realized"—generally upon sale of an appreciated asset. And even when gains are realized, top-bracket individuals pay lower tax rates on capital gains than on so-called "ordinary" income.

As a result, investment markets that primarily service the well off are often designed to maximize the share of profits that are in the form of capital gains—both realized and unrealized. Indeed, on individual tax returns, total realized capital gains exceed total reported stock dividends by about 43%.

Which is not to say that capital gains are common for most taxpayers. In fact, only one tax return in every twelve filed reports any capital gains at all. Up to $100,000 in total income, dividends exceed reported gains. But for the highest income people—making more than $200,000 a year—realized capital gains exceed the total combined amount of both dividends and taxable interest.

Average Capital Gains, Dividends & Taxable Interest
By Family Income Group, 1994

Income ($-000)	Capital Gains	Dividends	Taxable Interest
<$10	$40	$70	$400
$10–20	70	200	820
$20–30	130	260	1,020
$30–40	210	390	1,360
$40–50	320	480	1,780
$50–75	660	870	2,180
$75–100	1,560	1,720	3,290
$100–200	4,630	4,110	6,310
$200+	66,070	27,120	33,660
All	**$1,320**	**$920**	**$1,920**

Averages for all taxpayers in group.
Source: CTJ Tax Model, January 1995.

Almost two-thirds of total capital gains reported on individual tax returns go to people whose incomes exceed $200,000. In contrast, only 7.6% of the total gains are reported by the three-quarters of tax filers with incomes of $50,000 or less. Thus, more than any other type of income, capital gains are concentrated at the very top of the income scale.

Because the taxation of capital gains is more important to the rich and politically powerful than the treatment of any other type of income, capital gains taxation has been extremely controversial over the years. At the onset of the income tax, realized gains were taxed at the same rates as other income—up to 77% during the World-War-I period. When the GOP regained the White House after the war, however, the top capital gains rate was set at 12.5%—half the regular top rate of 25% from 1925 to 1931. The top regular rate rose to 63% in 1932, but the 12.5% top capital gains rate was briefly retained.

The onset of the Great Depression and public disillusionment with stock speculation of the Roaring Twenties, however, led to increased capital gains tax rates in the 1930s. For a brief period, realized gains were taxed under a complicated schedule that taxed gains from very short-term investments in full, but excluded as much as 70% of gains from sales of assets held for more than 10 years. This system was widely criticized as unwieldy and complex, and in the early 1940s it was scrapped. For the next 25 years, taxpayers had the option of excluding half of their capital gains or paying a maximum rate of 25% (useful to those whose regular tax brackets exceeded 50%).

In the late 1960s, the special 25% maximum rate was repealed. In conjunction with other tax changes, the top capital gains rate rose to about 39% by the mid-1970s. Then in 1978, congressional Republicans joined by a substantial minority of Democrats pushed through a major capital gains tax cut. It lowered the top rate to 28%, by excluding 60% of realized capital gains from tax. The 1981 cut in the top regular tax rate on unearned income reduced the maximum capital gains rate even further, this time to only 20%—its lowest level since the Hoover administration.

In conjunction with sharply increased depreciation write-offs in 1981 (see below), the 1978 and 1981 capital gains tax cuts caused a proliferation of tax shelters. Unneeded, unprofitable and often empty office buildings sprung up all across the country in response to the new tax subsidies (helping set the stage for the savings and loan crisis later in the decade). Esoteric capital-gains-based tax shelters in items like collectibles, freight cars and llama breeding abounded. Tax-shelter "losses" reported on tax returns jumped from about $10 billion a year in the late seventies to $160 billion a year by 1985. And since the goal of most of the shelters was not only to defer taxes, but to convert ordinary income into lightly-taxed gains, reported capital gains jumped as well.

Proponents of low capital gains tax rates like to argue that the surge in capital gains after 1978 and 1981 proves that capital gains tax cuts cause the well off to cash in more unrealized gains, thereby mitigating (if not eliminating) the apparent revenue loss from a special low capital gains tax. To be sure, reported gains before exclusion did increase rapidly in the late seventies and early eighties. In nominal terms, they rose from $45 billion in 1977 to $80 billion in 1980 to $176 billion by 1985. Adjusted for the growth of the economy, this represents a 90% increase in reported gains from 1977 to 1985, and a 48% increase from 1980 to 1985. Since the maximum capital gains rate was cut in half between 1977 and 1985, even these figures indicate that the tax cut lost revenues. More important, since a very large share of the increased capital gains in the first half of the eighties represents tax-shelter conversions of ordinary income into gains, the surge in reported gains actually indicates a much greater revenue loss.

If, as Michael Kinsley and I have noted, we cut taxes in half for people named "Newt," then we surely would find that Newts reported much more income on tax returns. Indeed, total taxes paid by people named Newt might even go up. But that would merely reflect millions of people changing their names to Newt to avoid taxes, not some magical supply-side effect on Newts' incentives to work, save and earn money. The same is true of tax breaks for income called "capital gains."

Of course, looking only at national, aggregate data, it's hard to isolate the effects of capital gains tax changes from other factors that might affect capital gains realizations, such as the performance of the stock market and the overall economy. A recent study by Congressional Budget Office economists Leonard Bermun and William Rudolph, however, compared capital gains realizations by a large sample of taxpayers in various states, with widely different tax rates, over time. They found large transitory effects when the federal government made major changes in capital gains taxation.[1] But on a long-term basis, the study found very little correlation between capital gains tax rates and levels of realizations. In fact, in technical terms, the study found that "[t]he permanent elasticity is not significantly different from zero."

Despite all the debate over how much reduced capital gains taxes might affect the level of asset sales in the short run, it's really a side issue. The heart of the case for a capital gains tax break is that it encourages savings, investment, jobs and economic growth. And that case is astonishingly weak. Just look at what happened when capital gains taxes were cut in the past.

The 1978 Revenue Act, enacted in November of 1978, cut the maximum capital gains tax rate from 39% to 28%. Over the 12 months *prior* to enactment of that change, the real GDP grew by 5.8%. But *after* the 1978 capital gains tax cut was approved, the economy faltered. In fact, the GDP *dropped* by 1% over

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[1]Most notably, in Sept. of 1986, Congress approved the Tax Reform Act of 1986, which increased the maximum capital gains tax rate from 20% to 28%, effective Jan. 1, 1987. This caused a rush by investors to cash in capital gains before what had become a temporary 20% rate expired. As a result, realized capital gains in corporate stock were nearly seven times as large in Dec. of 1986 as they had been in Dec. of 1985.

the next year and a half. The annual growth rate for the two years following the 1978 capital gains tax cut was only 0.3%—5.5 percentage points lower than the growth rate prior to the cut.

In August of 1981, another capital gains tax cut was enacted, this time cutting the top rate to 20%. Over the 12 preceding months, the economy had grown by 3.5%, but in the 12 subsequent months the GDP *fell* by 2.8%. In the two years after the 1981 capital gains tax cut was enacted, the annual growth rate was only 1%—2.5 percentage points below the growth rate prior to the cut.

Contrary to the assertions of capital gains tax cut proponents, capital gains tax cuts have never led to improved economic performance. Tax laws that have *increased* the capital gains tax, however, typically *have* been followed by increased growth. After the 1976 Tax Reform Act was enacted, for example, the economy's growth rate jumped from 3.9% in the preceding 12 months to 5.2% over the next two years. Likewise, following enactment of the 1986 Tax Reform Act, the growth rate rose from 2.2% in the previous year to 3.8% over the next two years.

Date of Capital Gains Tax Cut	Jobless Rate	Two years later	Change
November 1978	5.8%	7.3%	+1.5%
August 1981	7.3%	9.3%	+2.0%
Date of Capital Gains Tax Hike	**Jobless Rate**	**Two years later**	**Change**
October 1976	7.6%	5.7%	-1.9%
October 1986	6.8%	5.2%	-1.6%

Source: U.S. Dept. of Labor, Bureau of Labor Statistics.

The record of capital gains tax cuts when it comes to jobs is equally dismal. In fact, the unemployment rate *rose* sharply after both the 1978 and 1981 capital gains tax cuts. Conversely, the jobless rate *fell* notably after the 1976 and 1986 capital gains tax hikes were enacted.

History belies the claims that low capital gains taxes stimulate the economy. The long-term economic case against capital gains tax loopholes is even stronger. In essence, capital gains tax cut proponents seem to believe that free markets don't work, that government needs to step in with subsidies designed to override the signals the market sends about the level and allocation of capital. But this idea that the government should be making investment decisions for business is terrible economics.

The truth is that paying people and corporations to make investments that otherwise make no business sense undermines economic growth. Capital gains tax breaks and other supply-side loopholes of the first half of the 1980s inspired construc-

Capital Gains Tax Changes & Economic Growth
(Changes in Real Gross Domestic Product)

Date Enacted	Growth in Prior Year	Annual Growth Rate Over Next 2 Years	Change in Growth Rate
Capital gains tax cuts:			
Nov. 6, 1978	+5.8%	+0.3%	-5.5%
Aug. 14, 1981	+3.5%	+1.0%	-2.5%
Capital gains tax increases:			
Oct. 4, 1976	+3.9%	+5.2%	+1.3%
Oct. 22, 1986	+2.2%	+3.8%	+1.6%

NOTE: Growth rates are from date of enactment of the capital gains changes.
Source: U.S. Dept. of Commerce. Compiled by Citizens for Tax Justice, 1992.

tion of tens of thousands of unneeded office buildings and led to myriad other dramatic and wasteful misallocations of American capital and effort. But they completely failed to produce increases in total savings or investment.

One of the key goals of the 1986 Tax Reform Act was to curb the harmful, tax-motivated economic distortions that the supply-side policies had produced. As the official report on the Act notes, in the loophole era "the output attainable from our capital resources was reduced because too much investment occurred in tax-favored sectors and too little investment occurred in sectors that were more productive but which were tax-disadvantaged."

Certainly, the last thing our economy needs is to divert our nation's capital stock into other tax-motivated schemes at the expense of more productive investments. The right thing for our economy is to reduce the government's monstrous long-term budget deficits and to close—rather than expand—economically harmful tax loopholes.

Details on existing capital gains tax breaks:

28% maximum rate: One of the greatest achievements of the 1986 Tax Reform Act was to tax realized capital gains at the same rates as wages, dividends or other income. (Previously, realized capital gains had been 60% tax-exempt). But in 1990, Congress reinstated a small capital gains preference, by capping the capital gains rate at 28% while setting the top regular income tax rate at 31%. In the 1993 budget bill, this capital gains preference was greatly expanded to provide what amounts to a 30% capital gains exclusion for top-bracket taxpayers (the difference between the new 39.6% top regular tax rate and the continuing 28% maximum capital gains rate). The 1993 act provided an additional 50% capital gains exclusion for profits from certain "risky" investments that are considered likely to fail. A staggering 96% of the tax savings from the current 28% maximum capital gains tax rate for individuals goes to the best off 1 percent of all taxpayers.

Current Capital Gains Tax Break (28% Maximum Rate)
By Family Income Group, 1994

Income Group ($-000)	% with Capital Gains	% of Total Capital Gains	Average Tax Break (all returns)	% of Total Tax Break
<$10	1.9%	0.5%	$ –	–
$10–20	3.5%	1.1%	–	–
$20–30	5.1%	1.7%	–	–
$30–40	7.2%	2.0%	–	–
$40–50	8.7%	2.3%	–	–
$50–75	13.3%	7.1%	–	–
$75–100	21.5%	6.2%	5	0.2%
$100–200	31.8%	13.8%	105	3.6%
$200+	48.5%	65.3%	8,510	96.2%
All	8.5%	100.0%	$ 115	100.0%

Source: CTJ Tax Model, January 1995.

Indefinite deferral of tax on unrealized capital gains: Capital gains are not taxed until assets are actually sold. As a result, investors can put off tax on their gains indefinitely. (They can also avoid tax on realized gains by selectively realizing losses on other investments in the same year.) This deferral is unavailable, of course, to most other kinds of income (such as savings account interest, even if the money is left in the bank). Multibillionaire Warren Buffett, for example, is said to pay extraordinarily little in federal income taxes despite his enormous wealth, because he has structured his investment company so that it hasn't paid a dividend since 1966. Instead, Buffett's $12 billion or so in accrued capital gains remain unrealized and thus untaxed.

Capital gains tax breaks for gifts and inheritances: Currently, heirs can sell inherited property and pay no tax on capital gains that accrued prior to the time they inherit. In other words, capital gains taxes on inherited property are completely forgiven. In the case of gifts, the recipient takes over the giver's "basis" in the donated property—generally the cost when the property was first acquired. That carryover of basis—rather than taxing the gain—allows a continued deferral of unrealized capital gains.

Special additional industry-specific capital gains tax breaks: Historically, favorable capital gains treatment has normally been limited to profits from the sale of investments (stocks, bonds, etc.). But several industries have succeeded in getting part of their normal business profits treated as capital gains. Special capital gains treatment is currently available for sales of timber, coal, and iron ore and for certain farm income.

Other special capital gains breaks include:

- Indefinite tax deferral for so-called "like-kind exchanges" of real estate. Normally, when someone sells appreciated property he or she must pay tax on the capital gain. But someone who sells rental real estate and later purchases other rental property can put off paying capital gains taxes on the sale indefinitely by pretending to have "exchanged" the properties with another investor.

- The refinancing loophole. Owners of investment assets that have gone up in value can cash in their capital gains without tax by borrowing against the appreciation. This is an enormous tax shelter for, among others, wealthy real estate speculators.

- An exception from the normal $3,000 annual limit on net capital loss deductions for losses on the sale of certain "small business corporate stock." Except for a $3,000 a year *de minimis* rule, realized capital losses can only be used to offset realized capital gains. Otherwise, investors with a portfolio of winners and losers could realize losses to wipe out taxes on their wages and other income, even though their total capital gains position (realized and unrealized) was positive. But for certain "small business corporate stock" investments, up to $100,000 in losses can be deducted. This subsidy is presumably designed to ease the pain of backing money-losing operations, and thereby encourage wealthy investors to invest in businesses that are unlikely to succeed.

- Indefinite deferral of tax on the sale of a broadcasting facility or cable system to a "certified minority-owned business," i.e., a company at least nominally owned or controlled by "a black, Hispanic, Asian American or Native American." The federal government has approved an astonishing 303 such "tax-deferral certificates" since this program began in 1979 (presumably using complex apartheid-style rules to assure that the potential nominal buyers met the racial classification requirements). On Wednesday, Jan. 4, 1995, the *Washington Post* reported on a particularly egregious example of how this tax subsidy works:

> "Viacom, the New York-based entertainment and media conglomerate, intends to sell its cable television systems for more than $2 billion to a minority-controlled enterprise under a program that would give Viacom a federal tax break of as much as $400 million, sources close to the company said. . . .
>
> "[C]orporate investors are putting up nearly all of the money for the purchase, but [black business executive Frank] Washington's management control of the [purchasing] partnership qualifies the group as minority-owned under FCC rules. Washington himself is investing slightly more than $1 million."

Apparently, this deal's "several giant corporate investors, including Tele-Communications, Inc., the world's biggest cable company," are paying Mr. Washington handsomely to use his name and race. In fact, Mr. Washington seems to have made his living on such deals since he came up with the idea for this particular racial preference while an official in the Carter administration. The *Post* reports that the Viacom deal would be Washington's fifth gorging at the "tax-deferral certificate" trough just since 1988. But whatever Mr. Washington personally clears on Viacom before he moves on to still another of these boondoggles, the bottom line is that the federal government has spent $400 million merely to make one multimillionaire, who happens to be black, even richer.

If the goal is to remedy the effects of racial discrimination, there must be better ways to spend $400 million than this offensive tax loophole.

Republican proposed additional capital gains tax breaks:

Total Capital Gain Tax Breaks If the GOP "Contract" is Adopted (1994 Income Levels)

Income	% of Total	Average
<$10,000	0.1%	$-2
$10-20,000	0.8%	-12
$20-30,000	1.2%	-22
$30-40,000	1.6%	-37
$40-50,000	1.9%	-61
$50-75,000	6.0%	-128
$75-100,000	5.3%	-310
$100-200,000	12.9%	-1,000
$200,000+	70.2%	-16,372
All	100.0%	$-304

The GOP Contract with America proposes to replace the current 28% maximum capital gains rate with much bigger tax breaks. They include a 50% exclusion and indexing the basis of assets for inflation—applicable both to individuals and corporations. According to the Treasury Department, these changes would cost $183 billion over the next ten years—mostly benefiting the very rich.

The combination of indexing and a 50% capital gains exclusion would on average exclude about two-thirds of all capital gains from taxation. For assets held for relatively short periods of time before sale, the exclusion could be close to 90%, while it would generally be lower for gains from sales of long-term holdings.[2]

The GOP's capital gains tax breaks would apply to corporations as well as individuals. As a result, large timber companies and certain other industries

[2] If an asset is going up in value by, say, 8% a year, while inflation is 3%, then indexing alone would cut the tax by 35% on the sale of the asset after one year. But if the asset is held for 20 years, indexing (alone) would cut the tax due by only 20%. When the GOP's proposed 50% exclusion is added on as well, the total exclusion for the one-year asset would be almost 70%, compared to 60% for the 20-year asset.

that are allowed to treat a large portion of their profits as capital gains could end up paying little or nothing in income taxes.

The tax-sheltering potential of the Republican capital gains breaks is staggering. Investments in depreciable property that actually lose money before tax could become highly profitable after tax under the plan.

Testifying before this Commitee a few weeks ago, the Treasury noted:

> "Increasing the preferential treatment of capital gains would create economic efficiency losses and make the tax system more complex by encouraging taxpayers to convert ordinary income into capital gains."

Even some conservative economists have expressed serious reservations about the GOP's proposed capital gains tax cuts. They note that capital gains are already the lowest taxed form of capital income (due to deferral and preferential rates), and they fear the likely waste of capital resources from new tax shelters. These are among the reasons why indexing, although it might seem attractive at first glance, is particularly inappropriate in the case of capital gains. In fact, indexing *any* type of capital income for inflation (whether interest, dividends, or whatever) is inappropriate unless interest costs are also indexed downward.

If the GOP capital gains tax plan is adopted, capital gains tax breaks going to the richest 1 percent of the population would soar to an average of almost $16,400 each per year. That's a very expensive subsidy to encourage uneconomic investments.

Accelerated depreciation

Born in scandal during the Nixon administration and the cause of many tax scandals thereafter, accelerated depreciation now is the largest of all corporate tax loopholes. Technically, accelerated depreciation lets companies write off the costs of their machinery and equipment faster than it actually wears out. In practice, that means sharply lower tax bills for companies that can take maximum advantage of the tax breaks.

In 1970 after the repeal of the investment tax credit the previous year, the Nixon Treasury Department sought a new way to subsidize corporate profits. What it came up with was called the "Asset Depreciation Range" or "ADR" system. Put into place by executive fiat, it shortened depreciation periods by 20% across the board and also allowed accelerated write-off methods that concentrated deductions in the early years that equipment is used.

Nixon's ADR approach was immediately challenged in court by public interest tax attorneys as far beyond Treasury's authority under the tax code and therefore an unconstitutional and shameful giveaway to big business. But while the lawsuit was pending, a heavily lobbied Congress passed Nixon's 1971 revenue act. That infamous bill retroactively ratified the ADR system, and reinstated the investment tax credit to boot. The combination was deadly for the corporate income tax. A sharp decline in corporate tax payments quickly ensued. Coincidentally or not, productivity growth also collapsed soon thereafter.

By the late seventies, widely publicized studies by the congressional Joint Committee on Taxation and the nonprofit Tax Analysts and Advocates were finding that many companies and even whole industries were paying effective tax rates far below those envisioned in the tax code. But worse was to come.

In 1979, Sen. Lloyd Bentsen (D-Tex.), Barber Conable (R-NY) and James Jones (D-Okla.) introduced a huge corporate tax cut bill. In it, they proposed to shorten depreciation periods and accelerate write-offs much more radically even than ADR. Disingenuously, Bentsen et al. claimed that their plan would cost only $2 billion a year. That was indeed the estimated cost of the plan in its first nine months. But the sponsors knew full well, although they never mentioned, that by its fifth year the plan was expected to cut business taxes by a staggering $50 billion annually.

Urged on by a massive corporate lobbying campaign, believing the low-cost promises of the sponsors and naively hoping to help the economy, hundreds of congressmen and Senators signed onto the Bentsen-Conable-Jones accelerated depreciation bill. In conjunction with an expanded investment tax credit, a version of the depreciation plan was adopted as part of President Reagan's hugely expensive 1981 tax cut act (and made retroactive to the start of 1981).

With that, the floodgates opened. By 1983, studies by Citizens for Tax Justice found that half of the largest and most profitable companies in the nation had paid no federal income tax at all in at least one of the years the depreciation changes had been in effect. More than a quarter of the 250 well-known companies surveyed paid nothing at all over the entire three-year period, despite $50 billion in pretax U.S. profits. General Electric, for example, reported $6.5 billion in pretax profits and $283 million in tax rebates. Boeing made $1.5 billion before tax and got $267 million in tax rebates. Dupont's pretax profits were $2.6 billion; after tax it made $132 million more! Subsequent CTJ studies found similar outrages in 1984, 1985 and 1986.

In response to public clamor, his own newfound misgivings and the disappointing economic results of the 1981 corporate tax cuts, Ronald Reagan helped lead the fight for the loophole-closing Tax Reform Act of 1986. The 1986 act repealed the investment tax credit and sharply reduced depreciation write-offs for buildings. The changes greatly scaled back corporate tax avoidance opportunities and made taxpayers out of most of the former corporate freeloaders.

While companies paid more in taxes after 1986, however, business investment flourished. To the chagrin of the supply-side advocates of corporate tax cuts, real business investment grew by 2.9% a year from 1986 to 1986. That was 43% faster than the paltry 1.9% growth rate from 1981 to 1986. Even more significant, while construction of unneeded office buildings tapered off after tax reform, business investment in industrial machinery and plants boomed. As money flowed out of wasteful tax shelters, industrial investment jumped by 5.1% a year from 1986 to 1989, after actually *falling* at a 2% annual rate from 1981 to 1986. As former Reagan Treasury official, J. Gregory Ballentine, told *Business Week*: "It's very difficult to find much relationship between [corporate tax breaks] and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

Despite its advances, the 1986 Tax Reform Act did not end corporate depreciation abuses. Even today, businesses are allowed to write off the cost of their machinery and equipment considerably faster than it actually wears out. This remaining loophole has proven much more expensive than originally anticipated by the drafters of the 1986 Tax Reform Act. In fact, accelerated depreciation tax breaks are expected to cost $164 billion over the next five years.

Like any tax break targeted to corporations, accelerated depreciation is primarily a windfall for the very well off. In fact, tax breaks from accelerated depreciation are worth more than $11,000 a year to people making more than $200,000.

Economists also complain—rightfully—that accelerated depreciation often skews investment decisions away from what makes the most business sense and toward tax-sheltering activities. This can, for example, favor short-term, tax-motivated investments over long-term investments. Moreover, when equipment is purchased with borrowed money, the current tax system produces outright "negative" tax rates—making such investments more profitable after tax than before tax! As a result, corporate buying and selling of excess tax breaks through equipment "leasing" deals have remained widespread (albeit not on the scale of the first half of the 1980s). General Electric, for example, avoided a total of $1 billion in federal income taxes from 1986 to 1992 due to activities of its leasing subsidiary, GE Capital Services.

Shares of Total Corporate Tax Breaks
By Family Income Group 1994

Income Group ($-000)	% of Total Corporate Tax Breaks
<$10	0.6%
$10–20	4.2%
$20–30	4.4%
$30–40	4.7%
$40–50	4.7%
$50–75	10.4%
$75–100	7.6%
$100–200	14.7%
$200+	48.7%
All	100.0%

Based on shares of reported capital income. CTJ Tax Model, Jan. 1995.

Republican proposed additional depreciation tax breaks

With its huge cost, terrible distribution and sad economic record, accelerated depreciation might seem to have little going for it. Indeed, some might see curbs on excessive depreciation as a promising target for reducing the federal budget deficit. The new GOP leadership in Congress, however, has promised quite the opposite in its Contract. In fact, through it's so-called "neutral cost recovery system," the GOP has proposed to expand depreciation tax subsidies far beyond their current levels. A quirk in the GOP approach causes it to raise corporate taxes in the very short run, and in a replay of the past, the Republicans are trying to count it as a revenue raiser. But the plan soon would add $30 billion a year or more to the budget deficit.

Under the Republican plan, rather than writing off the cost of machinery and buildings as they wear out, companies would write off considerably *more* than the actual cost. On a $10 million investment in machinery, for example, the GOP would allow almost $11.5 million in tax deductions over five years. Currently, excessive depreciation tax write-offs for a corporation buying $10 million in machinery are worth about $460,000 (in what economists call "present-value" terms). The Republican plan would boost value of the tax subsidy on such a purchase to more than $800,000.

Today's depreciation rules already reduce the effective tax rate on the profits from typical investments in machinery to about half the statutory 35% rate. But the GOP plan is intended to be the mathematical equivalent of writing off the full cost of capital investments—in machinery, buildings, land, etc.—immediately. Thus, the effective tax rate on profits from new corporate investments would be—at most—zero! For even partially debt-financed investments, the effective tax rates under the GOP plan would be sharply negative. Such investments thus would be much more profitable after-tax than before-tax.

If the Republican depreciation changes are adopted, there is no doubt that corporate tax-sheltering would proliferate, and that many major corporations would once again pay little or nothing in federal income taxes.

Mr. ZIMMER. Thank you, Mr. McIntyre.

We in the new majority appreciate your kind words for Ronald Reagan which follow the praise for President Reagan that we heard last night from President Clinton in the State of the Union Address.

As I recall Ronald Reagan's understanding of the 1986 Tax Act and the reason he signed it, there was a tradeoff. In exchange for the elimination of a wide array of deductions, some of which we consider incentives, the marginal—the top marginal tax rate was reduced to 28 percent.

You are very vocal and very passionate in arguing that we would undercut the understanding, the deal that was made in 1986. I did not hear your organization complain that the top marginal tax rate has been increased 40 percent higher than it was in the 1986 arrangement.

Mr. MCINTYRE. Well, you weren't listening, Mr. Chairman. We were very concerned—not that the top rate was not going to be increased some, it had to be to deal with the deficit—but about creating this large new capital gains differential. We argued very strenuously that a much lower top rate than we have now would be more appropriate if all income were treated the same.

We also argued very strenuously that rather than raising rates that loopholes ought to be closed. The solution they came up with, raising the top rate, was it horrible? No, I don't think so. But it was not what we recommended at all.

We felt very strongly in 1986 and we feel very strongly today that we should have a tax system with the lowest possible but progressive rates. The way you get there is not to have special subsidies for this or that activity that currently has favor in the Congress.

Mr. ZIMMER. Well, I believe what Ronald Reagan looked for was not so much progressivity or steeply graduated rates but rather rates that were as flat as possible. You say that fairness is undermined by this proposed legislation. I ask you, is it fair to tax someone on a gain that is solely attributable to inflation?

Mr. MCINTYRE. Well, most of the witnesses we have heard here today are from the venture capital area where to a very large degree the rate of return on these investments, successful ones, is so high that the inflation factor is negligible.

Now, there are investments where inflation matters. There are also many investments where deferral matters. And I don't think that anyone who has looked at it has done anything but conclude that capital gains are the lightest taxed form of capital income.

There was an op-ed piece by a very conservative University of Chicago professor in the Washington Post last week that made exactly that point, and suggested if you want to cut taxes on capital, the last place you would look would be capital gains because they are taxed so lightly already.

This proposal gets the rate down to something on the order of an 11 or 12 percent maximum rate if gains are realized. That seems to me to be far too low compared to other kinds of income.

Mr. ZIMMER. Could you answer my question? Do you believe it is fair to tax a gain, a nominal gain which is solely the result of inflation?

Mr. McINTYRE. Yes, as long as we allow interest deductions that are solely the result of inflation, yes, I do.

Mr. ZIMMER. What do you mean by that?

Mr. McINTYRE. I mean if you are going to index gains for inflation, you have to index debt for inflation. Otherwise, as one of the previous witnesses from the New York Bar Association pointed out, you would be giving people deductions for "losses" on investments that make money or break even. As you may recall from your previous career, we call that a tax shelter.

Mr. ZIMMER. Mr. Ture, you wish to respond.

Mr. TURE. Assistant Secretary Samuels tried to make that point in his testimony. You will find in my testimony a rebuttal of his arithmetic, which I think is grossly in error. It is incidentally a rebuttal of the statement Mr. McIntyre just made.

May I take the liberty of addressing something that Mr. McIntyre has brought up over and over again, using the term subsidy?

Mr. ZIMMER. Yes.

Mr. TURE. Let's be sure that we have correctly identified what a tax subsidy is. It is a tax provision that reduces the relative cost of something or other, whatever the tax object is, compared to the cost or prices of other things from what they would be absent taxes generally.

Now, what we have under existing law is a set of provisions that artificially raises the cost of saving relative to the cost of consumption.

It does so by adding tier after tier of taxes to the returns on income that people save. That subsidy is a negative subsidy. It is an enormous tax penalty. But what the proposed title I of H.R. 9 attempts to do is to moderate that penalty. It does not remove it. But it does moderate it with respect to, initially, a particular form of return on one's savings.

Mr. ZIMMER. Thank you very much.

The next inquiry will be from Congresswoman Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman.

Mr. McIntyre, you are our lightning rod, I gather. I want to ask you a question about your comment about the central government control aspects of the Contract provisions as we look at how we can benefit the private sector.

How do you explain or what is in your mind when you said to us that central planning is apparent to you in the Contract? How would you explain how a broad-based capital gains tax cut, for example, that applies equally to everybody resembles central planning?

Mr. McINTYRE. Well, as you know, Ms. Dunn, different kinds of investments pay their returns in different ways. Many of the venture capital activities, for example, pay their returns as capital gains.

In fact, overall capital gains are a bigger piece of returns than are dividends from corporate stock. But if you put in a special preference for capital gains that taxes them much more lightly than dividends or interest or other returns to capital, you will find that real estate does very well, that certain types of corporate investment do very well, and that that happens to the detriment of other kinds of investments.

If you have trouble figuring out which investments are preferred, then you could say it is incompetent central planning. But it is still central planning. It is what we saw in the early eighties and it was universally decried as a horrible government policy. We ended up with all those empty office buildings that nobody wanted to rent. We ended up with people investing in llama farming and all kinds of esoteric tax activities that made no sense in the market, but were undertaken because the Ways and Means Committee and the Senate Finance Committee put in tax incentives that encouraged such investments.

That is what I mean. If you believe in markets, you don't favor one investment over another. You can bring in every industry in America to testify here and they will explain that their products are wonderful and do great things. You can't subsidize them all and still run the government, so you end up choosing to subsidize some over others and you end up with bad economic results.

Ms. DUNN. Would any other panelist care to respond?

Mr. TURE. If I may, Mr. McIntyre has again used the word subsidy. What we have had since the creation of the contemporary income tax in the early 1900s is a tax system which not only taxes the amount of income that people save but then taxes the returns on that saving and taxes it and taxes it and taxes it.

Under the existing system, it is taxed if the returns are directly paid to the individual. Those returns are taxed. You have got a double tax right there. If, in fact, the individual has directed his saving into the ownership of corporate equity, the corporate returns on that corporate equity is taxed to the corporation. Insofar as the corporation distributes those as dividends, they are taxed to the individual recipient again. If instead the corporation retains those earnings, the value of the equity goes up, when the individual realizes the gains on that, that, too, is taxed. There are taxes at the State and local level on the same returns. There are property taxes. There are finally estate and gift taxes, transfer taxes.

It is as if we regard capital and the returns on it as sources of great evil in our society rather than as the primary sources of increases in productivity, real wage rates, and employment. We do not subsidize particular industries or particular activities by reducing one of those levels of additional tax on the returns on saving. I think it is a gross error to assert that that is the case, as Mr. McIntyre has done. Rather, reducing the tax rate on capital gains will represent a small but very important bite in reducing one of those extra tiers on the returns on saving.

It is a highly constructive measure. I wish that the committee were in a position, as Mr. Archer has frequently suggested, to go—to take a somewhat more thoroughgoing revision.

Ms. DUNN. Mr. Chairman, may I do one followup to Mr. McIntyre's statement?

Mr. ZIMMER. Yes.

Ms. DUNN. Mr. McIntyre, what in your mind would a fair Tax Code include?

Mr. MCINTYRE. What would it look like? Well, it would look like the system we established after 1986 minus another couple of hundred billion dollars in loopholes, which would then mean much lower rates.

So, for example, Representative Gephardt has suggested he is working on a sort of "Tax Reform, Part 2" plan, which would get rid of some of the remaining tax breaks in the code and lower the rates. I assume that would be attractive to some. It would be unattractive to those who benefit from the current breaks enough that they already pay less than the lower rates that would be proposed.

I think Representative Gephardt's approach would be a much better system. The top rate might end up being 30 percent, the bottom rate might be 12 or 13 percent, and that would mean that even if you tax capital gains like dividends and interest, the top rate wouldn't be much different than it is now.

Ms. DUNN. Thank you.

Mr. ZIMMER. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

First, let me start by saying that I guess by some of the comments that have been made by our last speaker that the previous speakers are not nice people. I mean, you have raped the system, you have unfairly profited, and I am sure it is at the expense of other people.

I don't think that we can ever have a system where all people will benefit. God forbid that we would have a system where the rich and the poor benefit. I don't think that we can have a system like that. There is no way that a job is good when you are making profits on it off of your businesses. So shame on all of you for the work that you have done in the past.

I brought up this question a couple of days ago and it has to do with competitiveness in the world. We talk about small entrepreneurs and biotech fields. One of the problems that we have in a global economy is making sure we have businesses that are competitive on a global market.

From what I understand, a lot of the developments don't just come from larger companies, a lot of the research and development and innovations come from startup companies, come from small companies. Can you address how you think that the reduction in the capital gains tax would help keep America competitive and therefore keep jobs in America?

Mr. DEHAVEN. If I might. As per your first comment, I would like to thank Mr. McIntyre. I now know what I am. I am a bragging supplicant. I didn't realize that until I got here.

I tried to make that point, Mr. Ensign, in my discussion that we find in the American Electronics Association that our smallest members are in competition with the Japanese and how the Chinese and as a matter of fact, we will in the next day or so, we will be releasing the latest statistics on trade with Japan and China and the deficit in the high-tech area is the worst it has ever been in history. The fact is that Japan isn't the major problem anymore; it is really China, and our deficit with China is huge and it is going to be shocking when those numbers come out.

This research and development is very expensive, as was pointed out, not only in the biotech field but in the electronics field. And the most important costs involved in subsidizing such a venture is the cost of capital.

All of the costs involved, which would include the cost of the tax system, market to cost of capital, the cost of labor and the cost of customer support, are generally ranked in that order such that the cost of access to the market and the cost of capital are by far the most, and by reducing the capital gains rate, it is going to put more money into the marketplace and it will reduce the rate substantially.

Mr. BECKMAN. Could I address that for a moment?

Clearly in the biotechnology sector, small entrepreneurs are the driving engine of biotechnology, and in our business, capital is the fuel of innovation. We frankly can't borrow any money because most of the companies, 90 percent or more, don't have revenues that come from product sales. There may be some interest income, but that is a dwindling asset as is our capital.

And clearly, tax issues and tax considerations which would support capital formation would be extremely important to this innovative industry. It is an industry right now that is—a good portion of it is close to imperiled, as cash balances are less than 1 year for 70 percent of the biotechnology industry. If this industry is to survive and this is a U.S.-dominated, world-class industry, we have got to find additional ways to capitalize it.

Mr. TURE. Mr. Ensign, can I relate something to you. Many years ago during the sixties, I was director of tax studies for the National Bureau of Economic Research. One of our projects was an interview study to find out what was the effect of ordinary taxes and capital gains tax on entrepreneurial activities in the high-tech, high-risk areas.

What the interviewer discovered—and I have forgotten exactly how many interviews he conducted—there was a very substantial number of them and most of them were with people who left one of the Cambridge universities for the purpose of setting up his own or her own shop to develop ideas developed in the laboratories or created in the laboratories of those universities and corporations. Without exception, every single one of them said, Had we been faced only with ordinary tax rates on whatever gains we could have realized on the development and successful development of our own innovations, we would not have left the shelter of the university and the corporation.

These products and processes and so forth to a very substantial extent would never have come into existence. It was the fact that those high risks, those very high costs of innovation could be offset to some substantial extent, those risks could be offset to some substantial extent by the less punitive treatment afforded by capital gains that allowed them to go out and venture.

I think that is something that you have been trying to say which I think is extraordinarily important to keep in mind.

Mr. ENSIGN. Thank you. Mr. Chairman, if I may make just one last comment.

Mr. ZIMMER. Yes.

Mr. ENSIGN. It is not a question. I am a veterinarian by profession. I am building my second animal hospital right now, and I would like you to think about this, Mr. McIntyre, 20 years ago when veterinarians came out of school, their sheepskin got them a loan from a bank and they were able to start up a business. They cannot get that anymore. You have to come up with 20 to 30 percent downpayment. It gives an advantage to people like me that can afford to go to a bank and get those loans.

Veterinarians coming out of school now need venture capital, they need people that are willing to invest in them, and if they can get a more favorable tax treatment with their capital gains there are more and more opportunities for young people coming up in those startup businesses.

Thank you, Mr. Chairman, for your indulgence.

Mr. LIETZKE. May I make a comment please.

Mr. ZIMMER. We are under the gun. Let me consult with Mr. Christensen. Would you like to try to get in the questioning now as you know we have about 9½ minutes to get to the floor.

Mr. CHRISTENSEN. Mr. Chairman, I would make it real brief and we have got 9½ to go.

Mr. ZIMMER. Just about, yes, to be on the floor.

Mr. CHRISTENSEN. Yes, I will make it very brief.

I want to just tell Mr. DeHaven that I appreciate everything you have done and everything you have gone through, and don't ever apologize for what you stand for because you are the American dream. And no matter what anybody at this panel may think, you are the creator of jobs in this country, and I appreciate everything you have gone through, and that goes for Mr. Beckman, Mr. Herring and Mr. Lietzke. I know that even though you are a senior vice president there, you are part of the private sector and I appreciate what you guys have done. Because of a shortage of time, I can't go into things I would like to talk with you about.

And, Dr. Ture, as a researcher who understands the private economy and the private sector, I want to thank you for your testimony here today.

And, gentlemen, I appreciate everything you do and stand for. Thank you.

Mr. ZIMMER. Thank you, Mr. Christensen.

I think we have time enough for Mr. Lietzke's remark if it is brief.

Mr. LIETZKE. A quick comment. Several people have mentioned that the things that fuel companies are certainly capital and that is an important piece of it. I think there is another piece that goes with that and that is the hard work and the effort of large numbers, probably millions, of employees who participate in making these companies successful and through the hard work that the employees go through, especially those that have some equity investment in the form of stock options or stock purchase plans.

It seems to me only fair that there be some return on that hard work and effort for the millions of people who really make these companies successful. So it is not the capital alone. It is the hard work and effort of the employees.

Mr. ZIMMER. Thank you very much, and thank you to the entire panel.

We will now recess until we return from the vote. Thank you very much.

[Recess.]

Mr. COLLINS [presiding]. We will call the meeting back to order and go ahead with our last panel.

I would like to introduce the panel. Bartow Shaw, president of Shaw, McLeod, Belser, & Hurlbutt, Inc., Sumter, S.C. And we have William C. Siegel, president, Society of American Foresters; Douglas P. Stinson, owner-manager of Cowlitz River Tree Farm, Toledo, Wash.; and Hon. William Stuckey, past president, Forest Farmers Association. And we will start with Mr. Shaw.

STATEMENT OF BARTOW S. SHAW, JR., PRESIDENT, SHAW, MCLEOD, BELSER, & HURLBUTT, INC., ON BEHALF OF THE AMERICAN FOREST & PAPER ASSOCIATION, AND THE FOREST INDUSTRIES COUNCIL ON TAXATION

Mr. Bartow Shaw. Thank you, Mr. Chairman.

My name is Bartow Shaw. I am president of the firm of Shaw, McLeod, Belser & Hurlbutt of Sumter, S.C. We are a forestry consulting firm managing timberland primarily for nonindustrial landowners.

I am also a timberlandowner myself. I am a member of the board of directors of the Forest Industries Council on Taxation, the national trade association which represents the forestry industries and nonindustrial landowners on all Federal tax issues.

In addition, I am an immediate past member of the board of directors of AF&PA, the American Forest & Paper Association. The AF&PA is a national trade association of the forest products and paper industry as well. AF&PA represents a vital national industry which accounts for over 7 percent of the total U.S. manufacturing output, employing some 1.6 million people. This industry ranks among the top 10 manufacturing employers in the United States and has an annual payroll of $49 billion on sales of over $200 billion. The industry utilizes timber grown on public lands from its own lands and from forests owned by almost 7 million nonindustrial private landowners.

I wish to thank you for providing me the opportunity to testify before this committee today on legislation that is vitally important to the landowners throughout the Nation. Forestowners are located in nearly every region of the Nation. They own 350 million acres of woodlands, encompassing more than 72 percent of all commercial forests.

The typical nonindustrial landowner is not a wealthy individual, owning an average of less than 50 acres of woodland and with an average household income of less than $50,000 per year. Our firm has served hundreds of nonindustrial clients for almost three decades, and I can relate from experience that a great many of them now face a return much lower than expected when they invested because of effects of the Tax Reform Act of 1986.

Since its enactment in 1944, capital gains treatment for timber dispositions has resulted in impressive gains in planting and productivity. However, tree planting has suffered a continual declining trend since 1986. According to the U.S. Forest Service, tree planting in the United States in 1993 was at its lowest level since 1980. The increase in the capital gains rates has been a major fact in causing this decline.

A more limited timber supply will lead to significantly greater pressure to increase timber removals from public lands at a time when those harvests are being reduced for a variety of reasons.

Less than 10 percent of the Nation's timber harvest comes from public lands. With the Nation now looking to the private sector for today's working forests and those of the future, the country's interests require a policy framework which is supportive of private forestry investments.

The House Republican Contract With America contains provisions drafted by the chairman of this committee which would cut the tax rate on capital gains by allowing all taxpayers, both individuals and corporations, to one, deduct one-half the amount of the net capital gains and two, adjust the basis for their capital assets for inflation.

This proposal is intended to encourage long-term investments and risk taking and to lower the country's cost of capital which will translate into greater economic growth and job creation.

AF&PA applauds and unequivocally endorses the Chairman's bold effort to improve the climate for long-term investments and capital formation.

Lowering the cost of the capital will help the forest products and paper industry compete in the global marketplace. The United States already imports more in forest products than it exports. In 1994 nearly 34 percent of our softwood lumber consumption was imported. Overseas suppliers, many of whom are given generous tax breaks and other subsidies, have a competitive advantage over U.S. producers in world markets. Indeed, most other industrial countries have lower capital gains rates than this country, and many countries impose no tax at all on the sale of capital assets. A reduction in the U.S. capital gains tax will help restore our industry's international competitiveness.

The Chairman's proposal would also be a powerful tool in encouraging private landowners to make important investments in reforestation. Rates of return are historically low compared to alternative investments with capital literally locked in the ground during a rotation period of 30 to 80 years or more. As subsequent shortages occur, tree growers cannot respond to short-term supply as with other commodities. Consequently, forestowners are very sensitive to recall factors that affect the economics of forestry. U.S. tax policy is one of those key elements.

In closing, let me emphasize our appreciation for the Chairman's tremendous efforts in developing the proposal before the committee today. It represents a commitment to a Federal tax policy which will provide future generations the multiple benefits of America's privately-owned forests.

The AF&PA and millions of forestowners will support your effort 100 percent, and we will work with you to ensure its ultimate enactment into law.

Thank you.

[The prepared statement follows:]

STATEMENT OF BARTOW S. SHAW, JR.

AMERICAN FOREST & PAPER ASSOCIATION

BEFORE THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 25, 1995

Mr. Chairman, my name is Bartow S. Shaw, Jr. I am President of the firm of Shaw, McLeod, Belser & Hurlbutt of Sumter, South Carolina. We are a forestry consulting firm managing timberland for non-industrial landowners. I am, also, a timberland owner myself. I am a member of the Board of Directors of the Forest Industries Council on Taxation, the national trade association which represents the forestry industries and non-industrial landowners on all federal forestry tax issues. In addition, I am an immediate past member of the Board of Directors of the American Forest and Paper Association (AF&PA), the national trade association of the forest products and paper industry. AF&PA represents a vital national industry which accounts for over 7 percent of the total United States manufacturing output. Its members account for more than 90 percent of domestic paper and recycled paper manufacturing capacity. Employing some 1.6 million people, this industry ranks among the top 10 manufacturing employers in 46 States, has an annual payroll of $49 billion on sales of over $200 billion, and is a significant exporter to global markets. The industry utilizes timber grown on public lands and from forests owned by almost seven million non-industrial, private landowners. I wish to thank you for providing me the opportunity to testify before the Committee today on legislation which is vitally important to landowners throughout the nation.

CAPITAL GAINS AND TIMBER

Forest owners -- from large corporations to small farmers -- are located in nearly every region of the nation. They own 350 million acres of woodlands, encompassing more than 72 percent of all commercial forests. The typical non-industrial landowner is not a wealthy individual, owning an average of less than 50 acres of woodland and with an average household income of less than $50,000 per year. The average non-industrial landowner's investment prior to 1986 will produce considerably less for retirement or college expenses than anticipated due to the change in the capital gains treatment. Our firm has served hundreds of non-industrial clients for almost three decades, and I can say with authority that a great many of them are in this unfortunate situation.

The Tax Reform Act of 1986 eliminated the existing differential for capital gains,creating a genuine economic hardship for timber growers. Taxes were increased on capital gains but decreased on alternative forms of investment. Timberland investors awoke to discover higher capital gains rates without any provision allowing them to average their income over the life of the investment. This is important because economic circumstances such as retirement often force landowners to receive a lifetime's gain on their timber income in one year. Now, many of these landowners and their heirs are rethinking plans for reforestation, which could cause a shortage of wood in the future.

Since its enactment in 1944, capital gains treatment for timber dispositions has resulted in impressive gains in planting and productivity. Today, in spite of increased harvests to meet consumer needs, there is actually more growing stock than in

1944. However, despite the fact that we plant more trees than we harvest, tree planting per se has declined since 1986. The increase in capital gains rates has been a major factor in causing this decline. Indeed, according to the U.S.D.A. Forest Service, tree planting in the United States in 1993 was at its lowest level since 1982.

And, of course, a more limited timber supply will lead to significantly greater pressure to harvest timber from public lands at a time when more public lands are already being withdrawn from harvesting for a variety of reasons. Timber harvests on public forests have declined over 50 percent from the levels of the mid 1980s. Now less than 10 percent of the nation's timber harvest comes from public lands. This has put intense pressure on private woodlands. With the nation now looking to the private sector for today's working forests and those of the future, the country's interests require a policy framework that is supportive of private forestry investments.

The House Republican "Contract with America" contains provisions drafted by the Chairman of this Committee which would substantially cut the tax rate on capital gains by allowing all taxpayers, both individuals and corporations, to (1) deduct one half of the amount of their net capital gains and (2) adjust the basis of their captital assets for inflation. This proposal is intended to encourage long-term investments and risk taking and to lower the country's cost of capital which will translate into greater economic growth and job creation. **AF&PA APPLAUDS AND UNEQUIVOCALLY ENDORSES** the Chairman's bold effort to improve the climate for long-term investments and capital formation.

The U.S. forest and paper industry must compete globally. Lowering the U.S. cost of capital will increase timber supply and help the entire industry compete in the international marketplace. The U.S. already imports more forest products than it exports. In 1994 nearly 34 percent of the U.S. softwood lumber consumption was imported. In addition, investments in timberland are moving overseas partly because of the shorter growing periods in the Southern Hemisphere and consequent quicker return on investment. And as the investment moves so do the jobs. A $1.0 billion decrease in imports could bring 20,000 jobs back home. Overseas suppliers, many of whom are given generous tax breaks and other subsidies, have a competitive advantage over U.S. producers on world markets. Indeed, most other industrial countries have lower capital gains rates than this country has and a number of countries impose no tax at all on the sale of capital assets. A reduction in the U.S. capital gains tax will help restore our industry's international competitiveness.

The Chairman's proposal would also be a particularly powerful tool for encouraging private landowners to make the necessary investments in reforestation. It takes between 15 and 75 years to grow timber for harvest, depending on the geographic region and product, making forestry an activity that is unlike almost every other economic endeavor. Timber growing requires substantial start-up investments and is burdened with uninsurable high risks of weather, disease, insects and fire. Rates of return are historically low compared to alternative investments, with capital literally locked in the ground during the rotation period. There is very little market liquidity in the initial years because trees cannot be economically harvested before maturity. Consequently, private forest owners are very sensitive to all factors that affect the economics of forestry. U.S. tax policy is one of those key elements.

Moreover, sound economic forestry policy encourages sound forestry management practices which serve to significantly enhance the overall environmental quality of our forests and their surrounding communities. For every year there is inadequate reforestation and less effective timber management, that year's lost planting is lost forever -- **a tree cannot be planted retroactively.** Our professionally managed forests provide vital wildlife enhancement, water quality, a hedge for soil erosion, provide for recreational needs and create aesthetic beauty. In fact, we are now learning more fully the critical role being played by reforestation in the effort to combat the so-called "greenhouse effect", while at the same time the land is growing trees for future wood supply.

We commend the Committee for putting forth a proposal that will significantly enhance the ability of the nation's tree growers to continue their stewardship of the land. We wish to emphasize that it is important that this proposal apply to all taxpayers whether corporate or individual. A preferential capital gains rate should not depend on the form in which one conducts business. If it does it is sure to promote economic distortions in the marketplace.

We also wish to note that we have met with Committee staff concerning one aspect of the proposal, in particular, the indexing provision for timber owners. We have developed an alternative to the basis adjustment concept for simplicity and the administrative ease of our many small landowners. Our alternative is embodied in legislation introduced during the last Congress, the Reforestation Tax Act, H.R. 960. This alternative reduces gain by percentage adjustments intended to approximate the rate of inflation for every year the timber was held. Our approach tries to provide a simple way to compensate tree farmers for the effects of inflation over the very long periods of time they hold their investments.

In closing let me emphasize once again our appreciation and commendation for the Chairman's long and hard efforts in developing the proposal before the Committee today. The AF&PA and millions of forest owners will support your effort 100 percent and will work with you to insure its ultimate enactment into law.

Mr. COLLINS. Thank you, Mr. Shaw.

Now, we will go to Mr. Siegel.

STATEMENT OF WILLIAM C. SIEGEL, PRESIDENT, SOCIETY OF AMERICAN FORESTERS

Mr. SIEGEL. Thank you, Mr. Chairman.

My name is William Siegel. I am president of the Society of American Foresters, more commonly called SAF. The society, 18,000 members strong, is the scientific and educational association that represents the forestry profession in the United States. I also have my own consulting business in which I specialize in forest resource taxation and the legal and estate planning aspects of forestry. I am also a timberlandowner.

I am very pleased to be here today to comment on the capital gains treatment of income derived from timber investments.

The central focus of my testimony today is embodied in the Chairman's bill, H.R. 9, the Job Creation and Wage Enhancement Act of 1995. The SAF commends the Chairman and his cosponsors on this endeavor.

I would like to begin my testimony this afternoon with a summary of my comments. The Society of American Foresters support Federal tax policies that address the unique nature of timber management programs and thus treat forestry investments fairly in comparison to other capital ventures. Affected policy should be fair to forestowners to encourage the application of sound, professional, prescribed forest management practices on private woodlands and contribute to the expected increase in national demand for timber in the years ahead.

Historically, this Nation has looked to its 347 million acres of private forest for a substantial portion of its timber needs. Approximately 72 percent of the Nation's commercial timber property is owned by individuals and companies. The rise in demand and the curtailment of harvesting from public forests will place an increasingly heavy burden—in fact, is placing an increasingly heavy burden—on these private woodlands, since as a group they are the most productive.

Investments in private forest management are unique in many respects. Forestry investments must be held for long periods of time with little return in the interim. It takes 20 to 120 years, depending upon the species and the part of the country and the landowner's management objectives, to grow timber to be used in manufacturing solid wood products such as lumber, plywood and furniture.

Furthermore, it takes 10 to 40 years to grow timber for use in the production of pulp and paper products. Because of the long-term nature of forestry investments, they are often subject to substantial natural risk. Natural disasters impose a significant adverse impact on our Nation's forests.

Timber investments also suffer from wide-range, rapid market fluctuations, due in part to some domestic situations but also to heavy international competition in the global timber market. Timber investments typically have a low degree of liquidity in much of the investment cycle because of the need to allow the resource to achieve maturity before it can be economically harvested.

Furthermore, forestry investments often yield rates of return that are less than many other capital investment opportunities. Many private woodlandowners in the United States have made substantial long-term forestry investments on the premise that the timber capital gains provisions of the Federal income tax law which were put into the Federal code in 1943 would remain in place during the lifetime of their investments.

The elimination of the long-term gain rate differential has been extremely costly to private owners in terms of return on investment. In some cases, the Federal income tax on timber sale proceeds has nearly doubled, and in some extreme cases has more than doubled under the tax prohibitions contained in the Tax Reform Act of 1986 and later legislation.

In addition, taxpayers in some of the States that use federally adjusted gross income as the State income base have experienced substantial increases in State income taxes on their timber returns.

The Society of American Foresters believes that Congress broke faith with private timberowners by passing tax changes that have had such a substantial impact on their long-term investment.

Preferential treatment of long-term capital gains income stimulates capital formation, lessens the tax burden because the bunching of gains, which is very typical of timber investments, decreases the detriments to sale of capital assets and compensates for the negative impact of inflation on capital gains taxes.

One way to address this is for Congress to amend the treatment of forestry investments currently contained in the Tax Reform Act of 1986 and subsequent legislation to allow for adjustments for inflation on the original cost of timber owned by private forestlandowners. This type of provision would tax landowners on the real gain, not the inflationary gain, from harvesting their timber investment.

A restructuring of the Tax Code to reflect this recommendation would provide a measure of compensation to those who choose to invest in forestry by recognizing the long-term nature of timber investments. Of course, a 50-percent exclusion would be more economically favorable to timber investments.

Let me close by saying that because private woodlands are vital to our Nation's timber supply, because they provide many noncommercial benefits as well as commercial benefits, and because private forestry investments are unique, the Society of American Foresters supports public policies that encourage sustained investments in private forest management, increase stability of private forest ownership, and guard against the conversion of our Nation's private forest land to nonforestry and nonrenewable natural resource use such as commercial and residential development.

This concludes my testimony this afternoon, Mr. Chairman. Thank you very much for allowing me to present my testimony.

[The prepared statement follows:]

COMMENTS ON THE CAPITAL GAINS TREATMENT OF INCOME DERIVED FROM TIMBER INVESTMENTS

Testimony by William C. Siegel, President
Society of American Foresters

before the

United States House of Representatives

COMMITTEE ON WAYS AND MEANS

January 25, 1995

Mr. Chairman, my name is William C. Siegel. I am the President of the Society of American Foresters (SAF). The Society, 18,000 members strong, is the scientific and educational association representing the forestry profession in the United States, including public and private practitioners, researchers, administrators, educators, and students. Our primary objective is to advance the science, technology, education, and practice of professional forestry for the benefit of society.

The public policy activities of SAF are grounded in scientific knowledge and professional judgment. It is from this perspective that we review proposed forestry and related natural resource programs to determine their adequacy to meet stated objectives and public needs. I am especially pleased to be here today to comment on the capital gains treatment of income derived from timber investments.

Forecasts by the U.S. Forest Service and by many private and university analysts indicate that demand for timber from U.S. forests will continue to rise over the next 50 years.

Historically, the nation has looked to its three hundred forty seven million acres of private forests for a substantial portion of its timber needs; 72% of the nation's timberland estate is owned by individuals and companies. The rise in demand, and the curtailment of harvesting from public forests, will place an increasingly heavy burden on these private woodlands since, as a group, they are the most productive.

Other demands on private forests are also steadily increasing. Urban expansion, rural homesites, highway construction, and utility rights-of-way all continually reduce the total private acreage available for timber growing. In addition, many federal forestlands have been withdrawn from timber production altogether by being designated as wilderness and other special management areas, with more withdrawals likely. Declining budgets, environmental concerns, and greater demand for nontimber uses have further reduced the public sector's contribution to the nation's timber harvest. Thus, there is increasing pressure to rely on forests established and maintained by direct private investment.

Prior to 1944, if landowners harvested their own timber and then either sold it or used it in their businesses, the gain was taxed as ordinary income. Proceeds received under a timber-cutting contract, based on an agreed price per unit measure (as opposed to one lump-sum price for all of the timber) were also treated as ordinary income. On the other hand, income from the liquidation of a timber stand by a lump-sum sale was classified as a capital gain. Thus, if forest owners tried to manage their woodlands according to certain recommended forestry practices, the receipts were treated as ordinary income. Timber owners therefore found that liquidation worked to their distinct advantage. Instability of forest ownership and poor forestry practices were actually encouraged by the tax-law requirement that timber be liquidated to obtain capital-gains treatment.

Congress responded to a growing forest-liquidation problem and to the complaints of inequity by enacting Section 117(k) of the Internal Revenue Code in 1943 which became effective in 1944. This legislation placed owners who cut their timber themselves or who disposed of it under a pay-as-cut contract, in the same capital-gains status as nonmanaging forest owners who sold their timber outright in infrequent lump-sum transactions or who disposed of their entire property. Section 117(k) was subsequently reenacted in 1954 as Section 631. Section 631 remains in the federal tax code today despite the fact that under the 1986 Tax Reform Act there is no longer a tax-rate advantage for most timber owners in classifying timber income as a long-term capital gain.

Investments in private-forest management are unique in many respects. Forest investments must be held for long periods of time. It takes 20-120 years, depending on the species and the landowner's management objectives, to grow timber to be used in manufacturing solid wood products such as lumber, plywood, and furniture. Furthermore, it takes 12-40 years to grow timber for use in the production of pulp and paper products.

Because of the long term nature of forestry investments, they are often subject to substantial natural risk. Natural disasters impose a significant adverse impact on our nation's forests. The Mt. St. Helens eruption of 1980, Hurricanes Hugo and Andrew, the mid-South and Atlantic Coast ice storms of 1993 and 1994, Southern Pine Beetle infestation, American Chestnut Blight, and the recent wildfires in the west are just a few examples of the natural phenomena that have placed our nation's private forests at risk.

Timber investments suffer greatly from wide and rapid market fluctuations, due in part to heavy international competition in the global timber market. Virtually every major timber-producing country in the world, with the exception of those countries in the Pacific Rim, to further its public policy, provides special tax treatment and other financial assistance for private-forestry investments. These policies were enacted in recognition of the unique nature of timber growing and the special problems faced by timber investors. The benefits, in many instances, far exceed those offered in the United States.

Timber investments typically have a low degree of liquidity in much of the investment cycle because of the need to allow the resource to achieve maturity before it can be economically harvested. Furthermore, forestry investments often yield rates of return that are less than many other capital investment opportunities. On the positive side, however, woodland owners are often able to hold their timber for optimum market conditions without suffering a loss or diminution of capital. Successful reestablishment of softwood and hardwood forests following harvest usually requires large expenditures for both reforestation and for subsequent management. If appropriate practices are not followed, the site's productive potential is very likely to be lost to competition from brush, weeds, and low-value species. In recent years, many thousands of private owners have invested hundreds of dollars per acre in establishing new forest stands. These costs, and some on-going management expenditures, have to be carried for many years before a return on the investment is realized.

Many private woodland owners made substantial long-term forestry investments on the premise that the timber capital-gains provisions of federal income tax law would remain in place during the lifetime of their investments. There is also continuing debate about the effect on small non-industrial landowners who may be more affected by limits on their ability to deduct timber-management costs. The elimination of the long-term gain rate differential has been extremely costly to private owners in terms of return on investment. In some cases, the federal income tax on timber-sale proceeds has nearly doubled under the tax provisions contained in the Tax Reform Act of 1986, and later legislation. In addition, taxpayers in some of the states that use federal adjusted gross income as the state income tax base have experienced substantial increases in state income taxes. The Society of American Foresters believes that Congress broke faith with private timber owners by passing tax changes that have had such a substantial impact on their long-term investment.

Preferential treatment of long-term capital gain income stimulates capital formation, lessens the tax burden (under a progressive tax-rate system) caused by the bunching of gains, decreases the tax deterrent to sale of capital assets, and compensates for the negative impact of inflation on capital-gains taxes. Congress should amend the treatment of forestry investments currently contained in the Tax Reform Act of 1986, and subsequent legislation, to allow for adjustments for inflation on the original cost of the timber owned by private forest landowners. The inflation rate adjustment should be obtained by utilizing the Consumer Price Index, Treasury Bill rates, or by other similar means. This provision would tax landowners on the real gain, not the inflationary gain, from liquidating their timber investment. A restructuring of the tax code to reflect this recommendation would provide a measure of compensation to those who chose to invest in forestry by recognizing the long-term nature of timber investments.

Because private woodlands are vital to our nation's timber supply, because they provide noncommercial benefits, and because private-forest investments are unique, the Society of American Foresters supports public policies that encourage sustained investments in private-forest management, increase the stability of private-forest ownership, and guard against the conversion of our nation's private forestland to non-forestry and non-renewable natural resources use such as commercial and residential development.

In summary, the Society of American Foresters supports federal tax policies that address the unique nature of timber management programs and, thus, treat forestry investments fairly in comparison to other capital ventures. Effective policies should be fair to forest owners; encourage the application of sound, professionally prescribed forest-management practices on private woodlands; and contribute to the expected increase in national demand for timber in the years ahead.

Mr. COLLINS. And thank you. And I want to assure each of you that your full statements will be entered into the record. The first two have been right noticeable to follow that light there in front of you. We appreciate it.

I am going to call on Mr. Christensen for the next introduction.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. On behalf of my colleague from Washington, Congresswoman Jennifer Dunn, I am pleased to welcome Doug Stinson to the panel. Doug and his family own the Cowlitz Ridge Tree Farm in Washington State.

Doug's love for trees began in Missouri on his family's farm. When he was 14, he planted his first stand of trees. He pursued an education in forestry and received a degree in forestry from the University of Missouri in 1955. Since then, he has worked for the U.S. Forest Service in Alaska, planted his own tree farm in Toledo, Wash., married Fay Marie and has three children. He has been named Tree Farmer of the Year in Washington State and Western Regional Tree Farmer of the Year.

Doug is a member of the Olympic National Forestry Citizen Advisory Board, past president and current board member of the Lewis County Chapter of Washington Farm Forestry Association, member of the Society of Foresters, chair of the Small Landowners Advisory Committee to the Commissioner of Public Lands. Doug led forestry studies in Sweden, England, New Zealand, and Tasmania.

Mr. Chairman, on behalf of the committee and especially on behalf of my highly respected colleague from Washington State, the Huskie State, it is my pleasure to welcome Mr. Stinson to this panel.

STATEMENT OF DOUGLAS P. STINSON, OWNER-MANAGER, COWLITZ RIDGE TREE FARM, ON BEHALF OF THE AMERICAN TREE FARM SYSTEM

Mr. STINSON. Thank you, Mr. Christensen. Those are very nice words, and I appreciate being here from the State of Washington.

Yes, my wife and my three children, we do own Cowlitz Ridge Tree Farm which encompasses 900 acres near Toledo, Wash. I am here today representing the American Tree Farm System, and we are a national network of 72,000 private landowners who have each made a commitment to protect water, wildlife, soil, and recreation opportunities, and at the same time grow trees for forest products. We are committed to sustainable forestry.

Since 1941 the American Tree Farm System has worked to encourage sound forestry by the Nation's 7 million forestlandowners. Those who meet the system's high standards are certified as tree farmers. I am proud to be speaking on their behalf. We are private citizens from all walks of life who take great pride in practicing forest stewardship on our land.

My first experience was mentioned here earlier of planting trees when I was 14 in the Missouri Ozarks. I think that started me on my career. And I am certain at that time I didn't understand the important relationship between what happens in this committee and what happens in the forest.

Today, after 33 years of forest land stewardship and 24 years as an owner of Cowlitz Ridge Tree Farm, that relationship is very clear to me. I have learned that tax policy has a major influence on how forestowners manage their land.

At Cowlitz Ridge Tree Farm we have four goals. First, is to earn a living, and second is to live in balance with nature, and third is to leave the land in better condition than when we acquired it, and fourth is to educate the public and other landowners on the value of good forest stewardship.

Our ability to accomplish the last three goals depends directly on our ability to do the first. Cowlitz Ridge is managed as an economically viable forest. We are operating on a sustained yield basis. In the last 20 years, we have harvested approximately 65 percent of our forest growth. In other words, we are growing more wood than we are harvesting.

Investing in timberland is not for the fainthearted or for people who want to make a lot of money fast. The fact is, forestry investments are a unique economic activity. If you are in forestry, you are in it for the long term. At Cowlitz Ridge, we plan our first commercial thinning 25 years after a new stand of trees is planted. The stand won't be harvested for another 35 years or more after that.

What this means, though, is that after we invest $325 per acre to establish and nurture a new stand of trees at Cowlitz Ridge, we won't generate any cash flow for 25 years and we have to wait between 60 and 80 years for the full return on our investment. That is a long time, especially when you have your capital literally locked up on the ground and subject to a host of natural risks like fire, wind, insects, and disease.

At Cowlitz Ridge, one of our most recent natural risks was a windstorm that occurred on Inauguration Day in 1993. Salvaging these trees was a real challenge. So when you add the potential for disaster to the normal financial risks associated with extremely long-term investments, you can begin to understand why tree farmers like me are sensitive to all the factors that affect the economics of forestry.

We are excellent stewards. We earn our living from the forest. We recognize our responsibilities as forestlandowners and leave our forests better than we acquired them, but the Tax Reform Act of 1986 changed the rules. Taxes were increased on capital gains from timber.

What does that mean for landowners? I am a tree farmer, not an economist, but I can tell you in plain terms what the loss of capital gains treatment meant to me and to people like me. Simply put, it reduced the amount of capital we had to reinvest in our forests.

Nonindustrial landowners like Cowlitz Ridge own 57 percent of the working forests in the United States. Many no doubt found without capital gains tax treatment for timber, that they had less to invest in their land or better places to put their money than forest lands.

In Washington State, 25,000 acres of prime forestland is annually converted to other uses. This is a definite sign that forestland investments are now a higher risk. Favorable capital gains treatment would help retain our forests for future generations.

At Cowlitz Ridge, we spend approximately $20,000 each year on forest regeneration and timber stand improvement. We protect and enhance wildlife habitat and watersheds. We exclude the 150 acres of wetlands from commercial harvest. We minimize soil disturbance when we harvest and keep our clearcuts small, 5 to 20 acres, because we replant immediately after we harvest and use large high-quality seedlings, we minimize herbicide use and avoid aerial spraying.

Cowlitz Ridge practices environmentally sound sustainable forestry and it is repeated on the tree farms all over the Nation. But please understand the work we do is possible only when we have a stable income and adequate profits to reinvest in our land.

Thank you.

Mr. COLLINS. Mr. Stinson, if you would like to go ahead and finish your statement, you have come a long way. Feel free to continue.

Mr. STINSON. I am just about done there, but I wanted to abide by your time.

At Cowlitz Ridge, for example, if the proposal before the committee were enacted, we would be able to continue earning our living from our forestland and be able to pass the forestland on to our children. Multiply this by millions of landowners and you can see how good tax policy, good forestry, and a good environment are all linked together.

[The prepared statement follows:]

STATEMENT OF DOUGLAS P. STINSON

COWLITZ RIDGE TREE FARM
TOLEDO, WASHINGTON

BEFORE THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 25, 1995

My name is Doug Stinson. I am a Tree Farmer from Washington State. I, along with my wife and our three children, own the Cowlitz Ridge Tree Farm -- four parcels of forestland that cover over 900 acres near Toledo, WA.

I am here today representing the American Tree Farm System. We are a national network of 72,000 private forest landowners who have each made a commitment to protect water, wildlife, soil and recreation opportunities and at the same grow trees fo: forest products. We are committed to sustainable forestry.

Since 1941, the American Tree Farm System has worked to encourage sound forestry by the nation's seven million forest landowners. Those who meet the System's high standards are certified as Tree Farmers. I'm proud to be speaking on their behalf. We are private citizens from all walks of life who take great pride in practicing forest stewardship on our land.

My very first experience with forestry took place when I was 14, on my family's farm in the Missouri Ozarks. I planted five acres of shortleaf pine. At the time, I'm certain I did not understand the important relationship between what happens in this Committee, and what happens in the forest.

Today, after 33 years of forest land stewardship and 24 years as an owner of Cowlitz Ridge Tree Farm, that relationship is very clear to me.

I have learned that tax policy has a major influence on how forest owners manage their land.

We have four goals at Cowlitz Ridge Tree Farm:

1. To earn a living.
2. To live in balance with nature.
3. To leave the land in better condition than when we purchased it.
4. To educate the public and other landowners on the value of good forest stewardship.

Our ability to accomplish the last three goals depends directly on our ability to do the first.

Cowlitz Ridge is managed as an economically viable forest. We are operating on a sustained yield basis. In the last 20 years we have harvested approximately 65% of our forest growth. In other words, we are growing more wood than we are harvesting.

Investing in timberland is not for the fainthearted or for people who want to make a lot of money fast.

The fact is, forestry investments are a unique economic activity. If you're in forestry, you're in it for the long-term. At Cowlitz Ridge, we plan our first commercial thinning twenty-five years after a new stand of trees is planted. The stand won't be harvested for another 35 years or more after that.

What this means, though, is that after we invest $325 per acre to establish and nurture a new stand of trees at Cowlitz Ridge, we won't generate any cash flow for 25 years and we have to wait between 60 and 80 years for the full return on that investment.

That's a long time -- especially when you have your capital literally locked up on the ground and subject to a host of natural risks like fire, wind, insects, and disease. At Cowlitz Ridge, one of our most recent natural risks was a wind storm that occurred on Inauguration Day in 1993. Salvaging these trees was a real challenge. So, when you add the potential for disaster to the normal financial risks associated with extremely long-term investments, you can begin to understand why Tree Farmers like me are sensitive to all the factors that affect the economics of forestry.

We are excellent stewards. We earn our living from the forest. We recognize our responsibilities as forest landowners and leave our forests better than we acquired them. But the Tax Reform Act of 1986 changed the rules. Taxes were increased on capital gains from timber but decreased on alternate forms of investment.

What does that mean for landowners? I'm a Tree Farmer, not an economist. But I can tell you in plain terms what the loss of capital gains treatment meant to me, and to people like me. Simply put, it reduced the amount of capital we had to reinvest in our forests and in some cases actually discouraged these investments altogether.

Non industrial landowners like Cowlitz Ridge own 57 percent of the working forests in the US. Many no doubt found, without capital gains tax treatment for timber, that they had less to invest in their land -- or better places to put their money than in forest lands.

In Washington state, 25,000 acres of prime forest land is annually converted to other uses. This is a definite sign that forest land investments are now a higher risk. Favorable capital gains treatment would help retain our forests for future generations.

At Cowlitz Ridge Tree Farm, we spend approximately $20,000 each year on forest regeneration and timber stand improvement. We protect and enhance wildlife habitat and watersheds. We have excluded the 150 acres of wetlands from commercial harvest. We minimize soil disturbance when we harvest, and keep our clearcuts small: 5 - 20 acres. Because we replant immediately after we harvest, and use large, high quality seedlings, we minimize herbicide use and avoid aerial spraying.

I hope, Mr. Chairman, if you are ever in Washington State, that you would visit Cowlitz Ridge. Along with Douglas fir, Western red cedar, red alder and Western hemlock, our tree farm has many other tree species, including grand fir, Pacific yew, cheery, maple, cascara, hawthorn, ash black cottonwood and Pacific dogwood. Species diversity is a key part of our management plan.

Cowlitz Ridge practices environmentally sound, sustainable forestry. And it is repeated on Tree Farms all over the nation. But please understand the work we do is possible only when we have a stable income and adequate profits to reinvest in our land.

At Cowlitz Ridge Tree Farm, for example, if the proposal before the Committee were enacted, we would be able to continue earning our living from our forestland and be able to pass the forestland on to our children. Multiply this by millions of landowners and you can see how good tax policy, good forestry and a good environment are all linked together.

With capital gains out of the tax code, I think the costs are just as clear: fewer trees planted, more pressure to harvest remaining woodlands, more conversion of forestland to other uses.

Last November, the American Tree Farm System had its first-ever national convention. Hundreds of tree farmers from around the country gathered in Williamsburg, Virginia. One thing was clear to me as I talked to my friends and that was; we really need favorable capital gains treatment returned. This Committee is now taking up that issue which is very important to Tree Farmers and it is one that can make a real difference in how our nation's forests are managed. If all 72,000 Tree Farmers were here with me, they would applaud your efforts to improve the climate for forestry investment.

Thank you.

Mr. COLLINS. Thank you, sir.

And our next panelist is the gentleman from Georgia, a former Member of this body, and Mr. Rangel has asked to introduce my fellow Georgian.

Mr. RANGEL. Mr. Chairman, thank you for this opportunity.

Bill Stuckey is an old friend, a former Member of the House. When I first came here, we shared offices on the same floor. He introduced me to boiled peanuts, yams, greens and even chitlins, and I understand today that he is now going to tell us about the plight of those involved in timber.

I know one thing, even though he is wealthy himself, he has always concerned himself about the working people that made this great country what it is, and I am certain that what he is going to tell us today will help us to make it easier for people to invest in America and in timber and to make us productive and competitive.

Thank you, Mr. Chairman.

Mr. COLLINS. Thank you.

Mr. Stuckey.

STATEMENT OF HON. WILLIAM S. STUCKEY, PAST PRESIDENT, FOREST FARMERS ASSOCIATION

Mr. STUCKEY. Thank you, Mr. Chairman. I am sure that was a wonderful introduction. I understood every word that you said, but I am not sure I understood every word that Mr. Rangel said, so I will go back and read that fine introduction in the record. Thank you.

Thank you, Charlie.

Mr. Chairman, members of the committee, I do appreciate this opportunity to appear here today on behalf of the Forest Farmers Association and to present to this committee their thoughts about the importance of the reduction in the capital gains tax on the sustainability and productivity of our Nation's forests.

Mr. Chairman, I am the immediate past president of the Forest Farmers Association and I am here today representing over 4,000 members whose combined holdings total over 45 million acres of privately held, nonindustrial timberland, in 17 Southern States.

Nationwide there are over 6 million independent timberlandowners in the United States that manage over 275 million acres of trees. This private, nonindustrial segment of the forestry community comprises over 60 percent of the timberland that is available to supply our Nation's lumber and paper needs.

I want to commend you and the numerous cosponsors of H.R. 9 for including capital gains reform in this legislation.

In title I, it contains a 50-percent reduction from taxation from the gains on capital assets including timber. This proposed tax reduction is extremely important to small tree farmers.

To date, the independent timberlandowner is being asked to supply more wood fiber and is being pushed to manage more intensely his acreage because of both market conditions and government policy. When government policy discourages the planting of trees through excessive taxation and increased regulation, then fewer trees will be grown, and that is not only bad for the economy, but it is bad for the environment.

In some ways, Mr. Chairman, tree growing is similar to buying a long-term bond that has a maturity date of 25 to 70 years from the present. There is no annual income, there is no Federal insurance, and there is only the hope that you will see your return on investment sometime during your children's lifetime.

The risks of fire, insects, or the reduction in the value of your timber asset from government action makes timber an even more speculative investment than a long-term bond. In that regard, tree farming is very unique and obviously very, very long term.

And, Mr. Chairman, I can assure you that it takes a very unique person who is willing to undertake such a long-term and uncertain investment. In fact, I think the ultimate act of optimism is this past year we planted about 3,000 acres of trees and I hope that I will live to harvest those trees because, as I said, I am assuming that is rather optimistic, but maybe my grandchildren will enjoy those.

Some nonindustrial timber growers own tracts of forestland that is in the hundreds, some even own them in the thousands of acres. But the truth is, most of the landowners are small, and they have 10, 20 or 30 acres of trees. These are not wealthy Americans seeking a tax break. These are forestlandowners that are hard-working, middle-class taxpayers. They are farmers, they are retirees, schoolteachers, and they are small town and rural citizens. They are the ones who love their land, and they work it diligently to manage it and make productive the natural resource asset that they are privileged to own.

Increasingly, stricter environmental regulations have placed limits on the timber acreage that is available for harvest from public lands. At the same time, since the loss of capital gains differential in 1986, the replant rates on small nonindustrial tracts of land has declined. The disparity between acres harvested and acres planted continues to grow. Environmental groups, private timberlandowners and the forest products industry all agree that it is critical that our U.S. tax policy be changed to provide greater incentives for reforestation efforts.

As a direct result of the loss of the capital gains in the 1986 act, many timberlandowners, particularly those from the South, are selling their timberland and they are investing in other investments that will provide them with a more certain return.

Others are not investing in timber management practices or in reforestation activities as they once were. While we know that lands can reforest naturally and that trees will grow with little expenditure from the owners, studies have shown that timber will regenerate significantly faster and it will produce better quality wood if it is managed and reforested properly.

The Archer capital gains bill will provide much-needed tax relief. Passing the capital gains reduction in H.R. 9 will provide this country with two very beneficial results: More trees and a better environment.

Simply put, allowing tree farmers to keep more of what they produce means that they will have more to reinvest in tree production and more to spend to ensure proper management of existing timberlands.

Mr. Chairman, since the Tax Reform Act of 1986, the Forest Farmers Association has worked very hard to see that a more favorable tax treatment of timber is restored. In the last Congress we supported H.R. 960, the Reforestation Tax Act, which was designed to provide narrow reasonable tax incentives that would encourage more active management of existing private timber lands.

The major points of that legislation were to provide a partial inflation adjustment. When timber is sold for purposes of determining section 631 gain, the gain would be reduced by 3 percent for every year that the timber was held. While this provision would not fully compensate for inflation, it would provide an incentive for those tree farmers who held their investments for a long time.

Number two, passive loss rules: The legislation would revise the material participation criteria under which tree farmers are required to actively participate for a certain number of hours each year in order to deduct normal operating expenses.

Number three, reforestation tax credit: This provision doubles the expended limit from $10,000 to $20,000, and it indexes the amount for inflation.

Number four, reforestation amortization: This provision doubles the limit to $20,000, indexes it to inflation, and reduces the 7-year amortization period to 5 years.

We have been grateful for the support of a number of Members of Congress for the goals of the Reforestation Act. In particular, I am grateful that the passive loss provision of the Reforestation Act can be introduced as separate legislation and will be considered by the Ways and Means Committee this year during the tax bill debate. This change in the treatment of passive loss for small landowners was badly needed to ensure that small tree farmers are not penalized for exercising best management practices on their land by being required to carry the expense of these activities for many years until actual harvesting is conducted.

Forestry consultants tell me that many small landowners are forgoing important management activities of their land because of unfair passive loss tax rules.

Mr. Chairman, I have exceeded my time, but I do appreciate the opportunity to present the Forest Farmers Association's views at this hearing. We applaud your efforts to provide capital gains tax relief. We are encouraged that legislation will emerge from this committee that will provide the necessary incentives to allow nonindustrial timberlandowners to invest more money in reforestation, management, and maintenance of timberlands so that they can continue to provide this country with an abundant affordable supply of timber.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF
MR. WILLIAM S. STUCKEY
FOREST FARMERS ASSOCIATION
ON
CAPITAL GAINS TAX REFORM PROVISIONS
OF
CONTRACT FOR AMERICA

WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 25, 1995

Mr. Chairman and Members of the Committee, I am delighted to have this opportunity to appear on behalf of the Forest Farmers Association to present to this committee our thoughts about the importance of a reduction in the Capital Gains Tax on the sustainability and productivity of this nation's forests.

Mr. Chairman, I am the immediate past president of the Forest Farmers Association and I am here today representing our approximately 4,000 members whose combined holdings total over 45 million acres of privately held non-industrial timberland, primarily in 17 southern states. Nationwide there are over six million independent timberland owners in the U.S. managing over 275 million acres of trees. This private, non-industrial segment of the forestry community comprises over 60 percent of the timberland available to supply our nations lumber and paper needs.

I want to commend you and the numerous co-sponsors of H.R. 9, the Job Creation and Wage Enhancement Act of 1995, for including Capital Gains Reform in this legislation. Title 1 contains a 50% deduction from taxation for the gains on capital assets, including timber. This proposed tax reduction is extremely important to small private tree farmers.

Today, the independent timberland owner is being asked to supply more wood fiber and is being pushed to manage more intensely his acreage because of both market conditions and government policy. When government policy discourages the planting of trees through excessive taxation and increased regulation, fewer trees will be grown which is not only bad for the economy, but bad for the environment.

In some ways tree growing is similar to buying a long-term bond with a maturity date 25 to 70 years from the present. There are no annual annuities, there is no federal insurance, there is only the hope that you will see your return on investment sometime during your children's lifetime. The risk of fire, insects or diminution in value of your timber asset from governmental action makes timber an even more speculative investment than a long-term bond. In that regard, tree farming is very unique and obviously very long term. Consequently it also takes a unique type of person willing to undertake such a long term and uncertain investment.

While some non-industrial timber growers own tracts of forested land in the hundreds, or even thousands, of acres, most are small landowners with ten, twenty, or fifty acres of trees. <u>These are not wealthy Americans seeking a tax break</u>. Rather, most forest landowners are hard working, middle-class taxpayers. They are farmers, retirees, school teachers, and small town and rural citizens, who love their land and work diligently to manage and make productive the natural resource asset they are privileged to own.

Increasing, stricter environmental regulations have placed limits on the timber acreage that is available for harvest from public lands. At the same time, since the loss of the capital gains differential in 1986, the replant rates on small non-industrial tracts of land has declined in many parts of the country. The disparity between acres harvested and acres planted continues to grow. Environmental groups, private timberland owners, and the forest products industry all agree that it is critical that our U.S. tax policy be changed to provide greater incentives for reforestation efforts. As a direct result of the loss of the capital gains in the 1986 Act, some timberland owners, particularly in the South, are selling their timberland and investing in something that will provide them with a more certain return. Others are not investing in timber management practices or in reforestation activities, as they once were. While we know that lands can reforest naturally and that trees can grow with little expenditure from their owners, studies have shown that timber will regenerate significantly faster and produce better quality wood if it is managed and reforested properly.

The Archer capital gains bill will provide much needed tax relief. Passing the capital gains deduction in H.R. 9 will provide this country with two very beneficial results - more trees and a better environment. Simply put, allowing tree farmers to keep more of what they produce means they will have more to reinvest in tree production and to spend to ensure proper management of existing timber land.

Mr. Chairman, since the Tax Reform Act of 1986, the Forest Farmers Association has worked to see that a more favorable tax treatment of timber is restored. In the last Congress we supported H.R. 960, the Reforestation Tax Act, which was designed to provide narrow, reasonable tax incentives to encourage more active management of existing private timberlands. The major points of this legislation were:

a) Providing a partial inflation adjustment - When timber is sold, for purposes of determining Section 631 gain, the gain would be reduced by three percent for every year that the timber was held. While this provision would not fully compensate for inflation, it would provide an incentive for those tree farmers who held their investments for a long time.

b) Passive loss rules - The legislation would revise the "material participation" criteria under which tree farmers are required to actively participate for a certain number of hours each year in order to deduct normal operating expenses.

c) Reforestation tax credit - This provision doubles the expenditure limit from $10,000 to $20,000 and indexes the amount for inflation.

d) Reforestation amortization - This provision doubles the limit to $20,000, indexes it to inflation, and reduces the seven-year amortization period to five years.

We have been grateful for the support of a number of Members of Congress for the goals of the Reforestation Tax Act. In particular, I am hopeful that the passive loss provision of the Reforestation Tax Act can be introduced as separate legislation and will be considered by the Ways and Means Committee this year during the tax bill debate. This change in the treatment of passive losses for small landowners is badly needed to ensure that small tree farmers are not penalized for exercising best management practices on their land by being required to carry the expense of these activities for many years until actual harvesting is conducted. Forestry consultants tell me that many small landowners are foregoing important management activities on their timberland because of unfair passive loss tax rules.

Mr. Chairman, I appreciate the opportunity to present the Forest Farmers Association's views at this hearing today. We applaud your efforts to provide capital gains tax relief. We are encouraged that legislation will emerge from this Committee that will provide the necessary incentives to allow non-industrial timberland owners to invest more money in reforestation, management, and maintenance of timberlands so that they can continue to provide this country with an abundant, affordable supply of timber.

Mr. COLLINS. Thank you, sir. It was similar to when I first arrived in Congress in 1993. Representative Montgomery was in the chair that morning, and he asked me, For what purpose did I rise? I said, I would like to address the House for 1 minute, but, Mr. Speaker, like you, I talk kind of slow so it may take me a minute and a half.

I appreciate that slow talk. Mr. Rangel even mentioned it a while ago when you first started up.

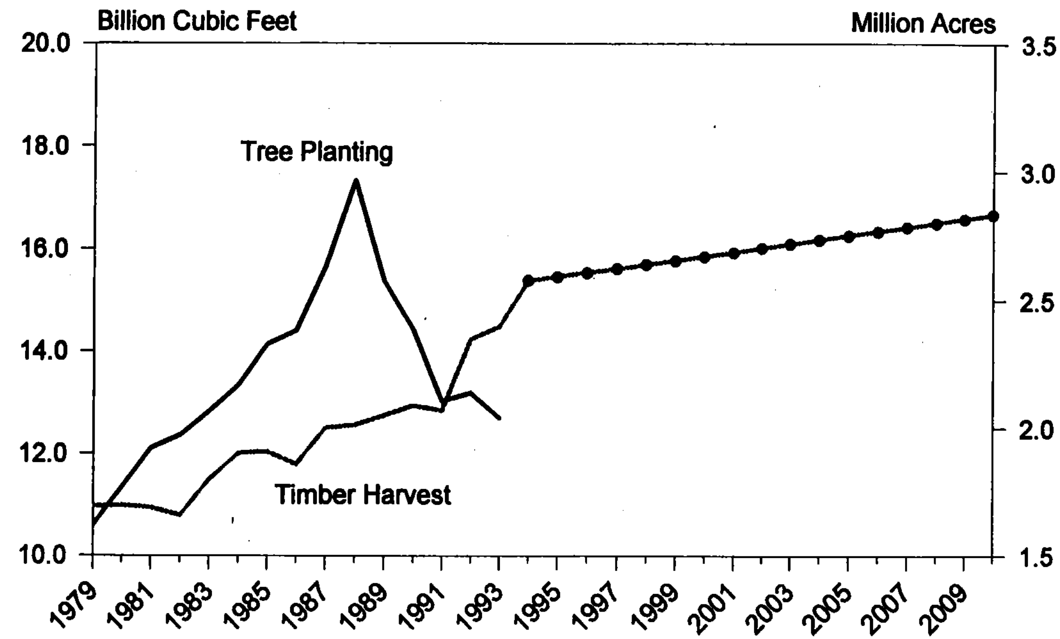
Mr. Stinson, I believe you are absolutely right on target when you say good tax policy and good forestry and good environmental issues are all linked together. That is a very, very good statement, but I have a couple of questions and I am going to yield to Mr. Rangel and then to Mr. Christensen.

Mr. Stuckey, you stated that tree planting in the United States has declined since 1986, the year in which the capital gains tax was increased. Do you have any statistics to really support this statement?

Mr. STUCKEY. Mr. Chairman, I don't have them with me, but we can provide them to the committee, for the record.

[The following was subsequently received:]

Harvest and Tree Planting on Private Lands



Source: USDA Forest Service ; AF&PA

Tree Planting and Direct Seeding on Private Land in the United States (Acres)

	Total Private	USDA Assisted	Total Unassisted
1979	1,618,973	258,802	1,360,171
1980	1,767,776	267,662	1,500,114
1981	1,920,848	264,991	1,655,857
1982	1,971,587	210,388	1,761,199
1983	2,065,458	209,490	1,855,968
1984	2,167,614	185,162	1,982,452
1985	2,326,187	256,088	2,070,099
1986	2,382,043	479,167	1,902,876
1987	2,628,925	976,291	1,652,634
1988	2,964,766	812,656	2,152,110
1989	2,576,886	866,259	1,710,627
1990	2,388,255	697,592	1,690,663
1991	2,105,443	396,072	1,709,371
1992	2,136,617	435,898	1,700,719
1993	2,041,215	467,102	1,574,113

Assisted Acres Include: CRP,FIP,ACP and SIP

Source: USDA Forest Service Annual Tree Planting Reports

Mr. COLLINS. How about any of the other panelists?

Mr. BARTOW SHAW. Mr. Chairman, I have statistics and empirical data supplied by the U.S. Forest Service which show that without question that the tree planting trend has been downward in a dramatic fashion, with the exception of the fact that there was a carryover lag before that downward trend for about 1 year after the 1986 Tax Act was implemented, and that was due primarily to the introduction at that time of the Conservation Reserve Program, which was a one-time marginal cropland set-aside program which encouraged, especially in the Southeast, planting trees. So if you take out the programs where there was assistance, the actual downward trend began and coincided with the Tax Reform Act of 1986.

I have a chart which dramatically shows that, which I would like to introduce in the record. On the vertical axis, there is the timber harvest on private lands which has continued upward, as I stated earlier in my testimony. The pressure on private land harvests is increasing as public land harvesting has decreased.

And on the other vertical axis is the tree planting activity, and it shows the decline rather dramatically. In addition, there are two backup tables which give that information.

This information was derived from U.S. Forest Service statistics. I would like to introduce that.

Mr. COLLINS. With no objection.

[At the time of printing, no information was received.]

Mr. COLLINS. You mentioned the reduction or the growth of harvesting trees is exceeding growth in many areas, and that a lot of the private landowners are harvesting their timber. Is it not true that other taxation, environmental regulations, endangered species, wetlands and all of these are contributing to that fact also?

Mr. BARTOW SHAW. That has had some impact, that is correct.

Mr. COLLINS. Mr. Stuckey, you stated that any capital gains tax reduction should apply to all taxpayers whether corporate or individual. Why is this so important to your industry?

Mr. STUCKEY. Mr. Chairman, as I stated in my testimony, it really is an act of faith when you go out there and you plant a tree and you know it is going to be 30 years at the earliest before you harvest it and probably 12 to 15 years before you have any income on it. You have got your money tied up for that length of time and you have to consider the fact that you have got forest, forest fires, some of the environmental issues. You certainly don't want a red-headed woodpecker to land in your land or part of it to be declared wetlands, but with all of the minefields that you have to go through and with inflation at the end of 30 years, you are hit with a heavy capital gains tax. There is not much of an incentive to plant trees.

Mr. COLLINS. You mentioned, too, that a lot of landowners are actually selling their timberlands or selling their farms with the timber and investing in other areas.

Mr. STUCKEY. That is correct.

Mr. COLLINS. Do we have any statistics other than the commercial or larger companies that show where people are actually investing in planting, buying land for the purpose of tree farming?

Mr. STUCKEY. Your smaller tree farm is not investing—reinvesting his money in his timber, and there again it is not profitable for him. It is not that much of an incentive and, as I said, it does take a unique person.

One of the traits that I have found in the tree farmer is that they really are people that have a love for the land. They are conservationists, and while most of them are not doing it for a profit, they do need a profit to sustain it. But those figures are available, I would assume, from the U.S. Forestry Service that they are, or that the Forest Farmers Association or some of the other associations could make those figures available. Bo, do you have anything?

Mr. BARTOW SHAW. The statistics from the U.S.—and I have those with me also in a form that it includes all States. The statistics—in fact, Mr. Rangel, I had the privilege of appearing before your subcommittee last year on a bill, the Reforestation Tax Act, and the question was asked on the declining acreage and the shortages that might come thereafter and I supplied that as followup the next week to Mr. Payne, and that indicated that the timberland in farm-type timberland was declining.

A true picture of the total nonindustrial land base is difficult to derive, but the closest thing to it was farm-type timberland which would be what Mr. Stuckey is talking about here.

Mr. COLLINS. What percentage of timberland is privately owned noncommercial?

Mr. STUCKEY. I believe it is about 60 percent.

Mr. SIEGEL. Noncommercial is about 57 percent, 57, 58 percent, nonindustrial commercial. Now you put the forest industries in there and then that rises to about 72 percent all private, but the nonindustrial private is about 57, 58 percent.

Mr. STUCKEY. That is close enough for government work.

Mr. COLLINS. That is close enough.

You mentioned earlier that we import a larger amount of lumber products or timber products into this Nation than we export. From what area do we primarily import?

Mr. BARTOW SHAW. Of course, a lot of it comes from Canada but the Scandinavian areas are a large producer of timber products. I do have some statistics here that you might be interested in on their beneficial tax ratios. A lot of investment now is going to Central and South American countries because of the short rotation time, but also because of the favorable tax advantages.

In Brazil, profit on sales of real estate before 1970 are tax exempt, and a 5-percent reduction of the taxable amount is granted for each year the property is held after that date onward. So in timber investment, which is long term, it is an effective, almost, a zero tax.

In Costa Rica, where there is a lot of investment, there is no capital gains tax on individuals or corporations. In New Zealand, there is no capital gains tax as such, and that is another area where there are heavy investments.

For every $1 billion that we import, that is about a $20,000 loss in U.S. jobs; and there is a definite trend. The magnitude has not reached dramatic proportions as yet, but it is continuing very rapidly toward having a significant impact.

Mr. COLLINS. If we are importing a lot of timber products or lumber products from Canada, there must be some advantage somewhere in price structure. What advantage does this Canadian lumber have over us?

Mr. BARTOW SHAW. Well, it is somewhat of a subsidized stumpage situation up there with the publicly controlled lands in Canada. And that has the biggest impact.

Mr. COLLINS. And capital gains such as H.R. 9 would give us some offset.

Mr. BARTOW SHAW. Any time we improve our position in the economics of growing timber in the United States, it is going to have an impact on offsetting the advantage of competing countries.

Mr. COLLINS. Thank you.

Mr. Rangel.

Mr. RANGEL. There is quite a bit of difference between H.R. 9, which is the bill before this committee, and last year's H.R. 960. Which one would be preferred by the timber farmers?

Mr. BARTOW SHAW. I would go ahead and address that. I think without question the capital gains provision is the preferred provision. The Reforestation Tax Act was originally introduced as a response to some of the concerns we have on the capital gains.

Mr. RANGEL. You and a lot of people are claiming we would not have substantial revenue loss with the capital gains provision, and indicate that by lowering the tax, it would encourage people to get more involved and to reinvest, and that would generate activity on the market, that now we get very little taxes because there is very little activity, and by reducing the rate, we would generate more activity and therefore gain more revenue.

If that is true, and in the timber industry now we find people that are looking for different types of investments. And as you said, Mr. Shaw, if there is no capital gains taxes in developing countries, if you lower the tax to make it more profitable to sell, is it possible that you would find that you will be losing investors in U.S. forestry?

Mr. BARTOW SHAW. I think any time you look at this as an investment—and again I hope you understand I am speaking for the AF&PA membership, the corporate membership, and also my experience with nonindustrial landowners as Mr. Stuckey has described, small timberlandowners especially in the Southeast—any kind of investment decision is going to involve a weighing of benefits and risks in returns, and there are risks in these areas. Therefore, any incremental benefit to timber growers in the United States would likely increase their investment and their thoughts of investment. The other part of it is that there is a certain affinity for the land that a lot of these folks have. It would encourage them to invest in these lands that they own where they are not investing now.

I would like to take a minute to read a quote of the U.S. Forest Service and the——

Mr. RANGEL. Let me—because I am going to have to yield my time. Are you saying that most of the people that you are concerned about are farmers that have made investment in their own land rather than those who make speculative investment in order to receive profits off of their investments? Is that what you are saying?

Mr. BARTOW SHAW. Well, there is a little of both. I am just saying we have a whole spectrum of timberlandowners.

Mr. RANGEL. OK. This is my last question, now. There are some that believe that scoring this capital gains tax cut is going to cause a dramatic revenue shortfall. Others disagree, of course.

Now, in the event that it is very expensive, everyone agrees that they are going to have to make certain that we have a balanced budget and that whatever losses we have in these tax provisions are made up by spending cuts.

Now, the spending cuts don't allow for touching Social Security, interest on our debt, and defense, and Medicare politically goes on and goes off, but no matter how you look at it, substantial cuts will have to be made in other programs, in forestry and agriculture—well, certainly agriculture is one of the big targets anyway, and forestry has no—I have no reason to believe that they will receive any special treatment.

Have you ever thought about whether or not how we pay for these cuts, how your industry would be better off, whether in the tax incentives or in the services and subsidies that are provided?

Mr. STUCKEY. Mr. Rangel, that is a wonderful way of putting it. And I can look at it and view it from your side, too. When income is cut off, you have got a problem balancing the budget, and I understand that better than anyone. And I am not here to defend all of the agricultural—some of the money that is spent in the agricultural area.

I truly believe that some of it could be reduced. But I think what you are looking at here is our country today is in a situation where the tree farmer is not able to make a living under the circumstances. All of these provisions will help, whether it is reforestation, whether it is passive loss, whether it is capital gains. But we cannot afford to not continue to replant our forests. And this is one of the things that the environmentalists and the industry agrees on, is that we cannot continue to have a loss in our reforestation.

Mr. RANGEL. Does that mean that you support the provisions of H.R. 9, and that you just have to take your chances as other people in the cutting arrangements that will be made?

In other words——

Mr. STUCKEY. We support—we support all of it, but——

Mr. RANGEL. Huh?

Mr. STUCKEY. We support H.R. 9, we support the reforestation that was introduced last year.

Mr. RANGEL. This is the taxwriting committee and that is all you should be concerned about.

Mr. STUCKEY. But I can tell you, and history bears this out, that people will be selling off their lands. They are going to look at today, not tomorrow.

Mr. RANGEL. I don't want to argue with you, Mr. Stuckey. All I am saying is this, that you are in front of the taxwriting committee. Everybody wants reduction in taxes. And you know as a former Member, no one likes to give it back to the people, their money, more than politicians and Members of Congress. So that is a done deal.

Now comes the question that whether we believe in it, don't believe it, we are mandated by the majority and by the President to make certain that we don't create a deficit. So that is done, politically certain things are off the table. Forestry is not one of them.

I have no idea how you would make out. Every industry has to make its own case. And I just want to make it clear that what you are saying now is that whatever happens down the line in cutting, that is a different committee, we will make our plea at a different time. But for right now, you want that tax relief.

See, we take the position that we don't know how much tax relief we want until we find out how painful the cuts are going to be, not the majority. Those of us in the minority, we want to cut as much taxes, as the other spending cuts cause us less pain. If it is not my ox that is being gored, let's do what we have to do.

So it is a consideration, and it really doesn't require an answer. But we ought to be alert that when you get from this hand of the government, something is going to be taken back in some other service that government is providing. But it has been a real education.

Good to see you again, Mr. Shaw, and you never let me down, Stuckey, from ball peanuts to save the trees.

Thank you.

Mr. COLLINS [presiding]. Thank you.

Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

And I will apologize to the panel. This is an interest near and dear to my heart since I have so many timber farms and farmers in my district in Washington State. I want to thank—I want to thank Mr. Christensen for doing the introduction of Mr. Stinson.

And I understand, Mr. Stinson, that you have not been asked a question, so I would first like to give you an opportunity to respond to any questions that have been addressed to the panel. Then I have an additional one for you.

Mr. STINSON. I would like to address the last question we just had here. And I think, you know, another way to look at this, we are talking about an investment in the future. And it is an investment in our forests and it is—you are going to get it paid back.

It may not be right tomorrow, but it is an investment in the future that is, I think, vital to the future generations coming along in this country. And I think we need to look at that really hard. And also the fact that it is going to help everybody, because our forests are very, very important not just for timber production, but for watersheds, wildlife, recreation.

There are many people who use the forests that don't own the forests. So there are some tremendous benefits to our country. And as our population keeps growing, we need more trees. If nothing more, just for oxygen. And so we can't go wrong. It is a win/win situation.

Mr. RANGEL. If the gentlelady would yield.

I agree with you 100 percent.

Ms. DUNN. It is my time, I yield.

Mr. RANGEL. I agree with you 100 percent, want you to know you are not going to have a problem with me. As a matter of fact, I always use the analogy of investing in young people and schools, because in the long run, you are going to get a return.

Ms. DUNN. Thank you.

And to the entire panel, particularly to you first, Mr. Stinson, since we have had discussions on at least one of these issues, if this capital gains tax cut is enacted, are there other obstacles in the Tax Code that we need to address such as passive loss, for example, that are discouraging to the reforestation industry?

Mr. STINSON. Well, the other tax issue for me that is a big one, is estate tax. And as a small tree farmer and a family held tree farm, one of the things that we look to in the future is how to be able to pass this down to our children. And that is a difficult problem right today. And I think probably that may be the greatest tax problem that most small family held tree farms face today.

Mr. SIEGEL. I would like to say something about the passive loss rules, Ms. Dunn, since you brought it up, and some of the other aspects of timber taxation.

Yes, the passive loss rules and the ability to deduct current expenses are a real problem with the small nonindustrial timberlandowner. Because the passive loss rules that were written by the IRS has, as a result of the 1986 Tax Reform Act, were written in general terms and did not take into consideration the unique aspects of certain types of investment such as timber growing, where more activity may be required on a landowner's part in 1 year and very little in another year, where we have many absentee landowners who, nevertheless, manage their lands very intensively, but are not personally involved, but use consultants, such as Mr. Shaw, to help manage their property.

Therefore, they have a very difficult time in meeting the provisions of the passive loss rules, and the ability, therefore, to deduct currently their expenses associated with their timber properties. In other words, they have to suspend their expenses, which cannot be recovered until timber is sold.

And as we know, that may be many, many years down the road. And that is why many of us in the forestry community would like to see the passive loss rules amended to take into consideration such unique investments such as timber that don't apply to the general terms of the passive loss rules.

Mr. SHAW. If I could take that thought a little bit further, there are several tests on whether you meet the qualifications for these ordinary maintenance costs during the year. One is a 100- to 500-hours test. You have to show that you do qualify.

If you have 500 hours or more, there is a safe harbor—you qualify automatically. If less than 100 hours, you really don't have any opportunity to show that you qualify.

A provision which would eliminate that requirement and put it in the category with the 100 to 500 hours by which you could show that you qualified, would allow a treegrower that has annual expenses such as firebreak plowing, even indirect costs such as property taxes, to deduct those during the time when they may only have periodic income, every 20 or 25 years. So this is an ongoing problem.

Those provisions were in H.R. 11, which passed both Houses of Congress in 1992. Unfortunately, that bill then was vetoed, so it never made it. But that is a disservice to our treegrowers. And it is a very big problem.

Ms. DUNN. Thank you very much.

Mr. COLLINS. Mr. Christensen.

Mr. CHRISTENSEN. I want to thank the panel for their testimony.

And, Mr. Stinson, I was quite intrigued with your testimony because I thought the cattle business was a tough business. Now I found another business that I don't think I ever want to get into.

Boy, after listening to your testimony, I have to give you a "hats off" for withstanding the insects and the fires and the natural disasters and everything for a long-term investment. And I didn't fully realize the impact of the forestry business.

And not only you, but you, Mr. Stuckey, I know you are also a grower as well. With a long-term investment like that, that is going to take anywhere from 20 to 70 years, depending upon the kind of wood that you are growing, what kind of profit are we looking at here?

If you were to grow, say, 100 acres of trees, what kind of investment do you have in 100 acres of trees and realization of a profit?

Mr. STINSON. Well, an acre of trees in the State of Washington at maturity have a value, varies, but I will give you a spread, $5,000 to $8,000.

Mr. CHRISTENSEN. OK.

Mr. STUCKEY. That wouldn't apply to Georgia. I wish it would.

Mr. STINSON. But they grow a little faster in Georgia. But I guess I think a bigger thing is most of the people who work the land, it is a love of the land that comes first. And growing the trees is very important because it is your livelihood. But if they didn't love the land and really have an interest there, you know, it probably wouldn't come together.

Mr. STUCKEY. And the price does fluctuate. Timber prices now are attractive, particularly in the South. We have had a lot of—a lot of rain.

And I hate to say this, because it is someone else's misfortune, but the price has gone up also because of the spotted owl in the Western States where they couldn't—where the demand is there but they couldn't go in and cut the timber. So they have had to fall back on some Southern timber.

Mr. CHRISTENSEN. OK.

Mr. SHAW. Just to add a little bit more, the anticipated return in the Southeast would be maybe 6 to 8 percent real rate of return, if you are in it for the entire rotation. But you have many, many obstacles. And the illiquidity of it, as was mentioned earlier.

If you invest $250 an acre in planting trees in the Southeast, you immediately have a $100 asset, because that is the market reaction.

So you have got a highly illiquid investment there for 6, 8, 10 years. That contributes a lot to the risk as well as the points mentioned in my testimony. Being from the Hurricane Hugo area, I can attest to the other risks involved there.

Mr. STUCKEY. I mentioned in my testimony, why put your money in land when you can get a long-term bond without the risk? And you are speaking of 6 to 8 percent, and there are some that would say that that is optimistic.

I do get some other value out of it, I enjoy the land, I enjoy the hunting, and that can be very enjoyable. But that kind of risk for a 6 to 8 percent return, I could put it in a bond, in a particular tax-free bond, and sit back and enjoy it.

Plus, I don't run the risk of somebody finding a red cockaded woodpecker on there, and then all of a sudden the investment being worth zero; or someone to come in and say, hey, this is wetlands, you can't come in and harvest your trees.

Mr. CHRISTENSEN. I want to thank the panel. I really appreciate your testimony, especially Mr. Stinson for coming all the way from Washington State.

Thank you, Mr. Chairman.

Mr. COLLINS. Thank you, Mr. Christensen.

There are very few acres of land that you can buy in Georgia, though, for $250 an acre, even though they are setout pines. Is that not true?

Mr. SHAW. Well, my analysis was not including the land value. That was what you would invest in site preparation and planting the trees.

Mr. STUCKEY. You can buy some 250-acre land now.

Mr. SHAW. Yes, you can.

Mr. COLLINS. In certain parts of the State.

Mr. STUCKEY. Sure.

Mr. COLLINS. But is it not true there are really three harvesting periods you are looking at in tree farming, that is, the pulp wood, and then when it gets to be what you call chip and saw, and then on into plywood material or bigger saw timber?

Mr. SHAW. Correct.

Mr. COLLINS. That is where you get your spread from a 15-year investment on up until a 40-, 50-, 60-year investment.

There has been a lot of talk about the fact that tax cuts could result in increased deficits. For the record, we want it to be known that the budget reconciliation that will be coming through very shortly, or very soon, will set the parameters that we will have the opportunity to meet for the tax reductions.

Those cuts are going to be there and those deficits are going to be covered. But is it not further true that a lack of incentive in this area, in this industry, will have a continued loss of timberland which will result in higher costs of building materials, which then will result in higher costs of housing? Is that not a fair statement to make?

Any of you.

Mr. SIEGEL. Sir, I think it is. I don't think there is any doubt that that is true, because of the set-asides on the public lands, the lowering of the timber cutting on public lands, and therefore that puts a lot more pressure for timber, for timber supplies, on private lands.

As we have heard, many of our private owners, particularly the nonindustrial private owners are not reinvesting after they are harvesting. So definitely if the supply shrinks and we are still going to have a housing demand, that definitely will result in higher prices for housing. And I don't think there are that many economists that disagree with that.

Mr. COLLINS. Then tax incentives could keep us a mix of the private landowner, the commercial landowner and the public land.

We thank each of you for being here. We appreciate your testimony. It is very helpful to us.

And the committee will stand adjourned until 10 a.m. tomorrow.

Thank you.

[Whereupon, at 3:47 p.m., the hearing was adjourned, to reconvene at 10 a.m., Tuesday, January 31, 1995.]

TAX PROVISIONS IN THE CONTRACT WITH AMERICA DESIGNED TO ENCOURAGE SAVINGS AND INVESTMENT

THURSDAY, JANUARY 26, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. If our guests will take seats, we can commence today's hearing. Today we continue our hearings on the savings and investment features of the Contract With America. Our focus today will be on the depreciation proposals and on the impact of the Contract on real estate.

The neutral cost recovery proposal in the Contract is intended to address an important issue for business—appropriate depreciation for business property for the creation of jobs. Economists have pointed out that the depreciation rules under the U.S. tax system do not allow businesses to recover fully their costs and place our companies at a competitive disadvantage when compared to companies operating in other countries.

The neutral cost recovery proposal has been put forth as one solution to the problem. I expect that we will hear from witnesses today who will have other possible alternatives. We welcome that input.

The Contract With America will also increase the immediate deductibility of capital items for small businesses, increasing that deductibility from $17,500 to $25,000 per year. This is both a simplification and an additional incentive for small businesses. If it were possible under our budgetary constraints, I would like to increase that amount for expensing even more.

Before moving to our first witnesses, I would like to recognize Mr. Cardin to make an opening statement on behalf of the minority, and as usual any additional opening statements by members of the committee can be put in the record in writing. After Mr. Cardin, we will proceed with our witnesses.

Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. Mr. Chairman, on my ride in from Baltimore this morning, I was listening to the news and listening to the account of congressional debate yesterday on the floor, and was listening to Henry Hyde talk about the importance of balancing the Federal budget. He reinforced the thought that I think all of us share, that the most important thing that we can do in order to increase investment in this Nation is to reduce the size of the Federal deficit.

Mr. Chairman, I applaud you for holding these hearings on provisions in the Tax Code in order to encourage additional private sector investment in this Nation. Democrats agree that our Nation lags far behind the industrial nations of the world in our savings ratios and that changes in our Tax Code can help us increase the amount of savings in this Nation, but let me underscore that the most important thing that we can do in order to help investment and savings is to reduce the size of the Federal deficit.

That is why many of us are concerned about how we are going to pay the $720 billion the Treasury has estimated to be the cost of the provisions in the Contract as they relate to the Tax Code. We should know how we are going to pay for these tax cuts before this committee moves forward in recommending these proposals to the full House.

The specific proposals that are before us concern tax changes for investment and savings, many of which enjoy bipartisan support. The 1993 tax bill included targeted capital gains relief, and the 50-percent exclusion, and indexing of capital gains enjoy support by both Democrats and Republicans, although I must point out, as a result of the hearings that have already taken place in this committee, there are certainly questions as to the complexity and the potential for shelters that I think this committee needs to deal with before reporting out such legislation.

I might also point out that the IRAs, individual retirement accounts, have had broad support by both Democrats and Republicans. President Clinton has included provisions concerning IRAs in his recommendations as well as in the Contract. Democrats and Republicans have traditionally supported those proposals.

But today's hearing is concerned with depreciation and the recommendation on the neutral cost recovery system. Perhaps this proposal has some merit in theory, but I don't believe it will work, and I am very interested in listening to the witnesses today explain how this proposal will increase investment and savings in our country and how we are going to pay the $120 billion price tag that the Treasury has estimated that costs the Treasury revenue outside of the budget window during the second 5 years of this proposal, and why taxpayers will choose to give up current savings on depreciation knowing the radical change that this makes in the Tax Code and the unlikelihood that Congress could allow such a provision to remain in place during the entire 10 years that Treasury has made its estimates.

I would also like the witnesses to address on this proposal why we should encourage the creation of tax shelters or how we could avoid tax shelters from being created. Examples have been given to us as to how individuals and companies would make decisions based upon the Tax Code rather than economic considerations because the indexing of the asset, but not of the interest cost, will allow tax shelters once again to be developed as a result of the Tax Code.

So, Mr. Chairman, I would hope that the witnesses in dealing with this proposal will explain first how we are going to pay for it, and, second, why we should reinstate tax shelters in the code and how we can deal with the complexity issues that have been raised by other witnesses.

Thank you, Mr. Chairman.

[The opening statements follow:]

OPENING STATEMENT OF HON. BENJAMIN L. CARDIN A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Thank you, Mr. Chairman. Today's hearing gives the committee an opportunity to address one of the most pressing economic problems facing our country -- the lack of adequate savings, and the resulting lack of capital for investment.

Among the major industrialized countries of the world, the U.S. savings rate lags far behind every country except the United Kingdom. The tax code is not the principal reason for our low savings rate, but we can encourage savings through the tax code, and we should do it.

The tax issues we will consider in this hearing include three major savings and investment proposals. First, we would offer individual and corporate taxpayers a 50% exclusion on capital gains, and would index capital gains for inflation occurring after December 31, 1994.

Democrats have long supported incentives through the tax code to encourage savings and investment. The 1993 tax bill included a targeted capital gains break for long-term investments in small businesses. That provision offered capital gains relief to small companies that have the toughest time raising needed capital.

The fifty percent capital gains exclusion now before our committee is much broader. The fifty percent exclusion will "unlock" assets and encourage new investment in our economy. By reducing the tax burden on investment returns, the exclusion will encourage taxpayers to shift assets from consumption to investment.

The proposal to index capital gains has a basic appeal. We already index many provisions of the tax code, so that tax is based on real rather than nominal, inflation-boosted income. Indexing capital gains will eventually take inflation out of the tax calculation.

But indexing raises some serious problems. It introduces a great level of complexity to the code. Taxpayers will be required to calculate the inflation impact on each individual asset, including, for example, the family car, greatly increasing individual record-keeping requirements.

Another potential problem with indexing is that if we index capital gains without indexing liabilities, we create the potential for tax shelter activity. I hope today's witnesses will address the shelter question, and particularly offer suggestions on how we might limit deductibility of debt financing connected to capital assets.

In addition to the capital gains proposals, we also have before us a plan to expand eligibility for Individual Retirement Accounts. President Clinton and the Republican Contract both have recognized the potential of IRAs to generate new savings, and, just as important, long-term savings. The long bipartisan history of support for IRAs on this committee is continued in these hearings.

Mr. Chairman, while I believe the capital gains and IRA proposals have merit and deserve support, I cannot say the same for the third leg of the contract's savings and investment package. The so-called "neutral cost recovery system" is a potentially disastrous idea masquerading as a simple, fair investment incentive.

NCRS, or "nickers", as it is known, aims to help solve a real problem for American business. But it is plainly the wrong answer to the right question. The question is, "What can we do to make the depreciation rules more simple and more favorable to investment?" The answer provided by NCRS is to add complexity, make depreciation a multiple choice game, raise the prospect of tax shelter activities, and try to hide $120 billion in lost revenues by pushing it outside the budget window.

The sensible alternative to "nickers" is to clean up the AMT treatment of depreciation. We can solve real problems facing real taxpayers without blowing a huge hole in the deficit. I will shortly introduce legislation to apply regular tax recovery periods to AMT depreciation. AMT relief makes a lot more sense than an untested, theoretical plan that needs a lot more work.

The final point I want to make is that the point of all these provisions is to increase savings. As we all know, the greatest single drag on savings in this country is the federal budget deficit. Each of the savings incentives I have mentioned will, by itself, lower revenues and increase the deficit.

The Treasury Department has calculated the total revenue loss under the tax provisions of the Contract at well in excess of $700 billion over ten years. In fact, it is troubling that several of the provisions of the contract are clearly structured to push revenue losses outside the scorekeeping window.

I hope today's witnesses will include in their comments suggestions on how we should offset the revenue losses that these proposals will generate. And I hope that all my colleagues on this committee will join in insisting that full offsets be identified before we move to final approval of the tax cuts.

Jim Ramstad

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA
January 26, 1994

Mr. Chairman, it is a pleasure to have such a distinguished panel of witnesses with us today to discuss neutral cost recovery. I have been extremely impressed with the excellent, real-world witnesses we have had before us to discuss each of the Contract provisions.

Currently, the tax code does not allow businesses to fully recover the cost of investments in depreciable business property. The Contract proposal would increase the depreciation deduction to account for inflation and the time value of money. It would also increase the amount of property that a small business can "expense."

These measures are essential to encouraging the type of investment our nation needs to maintain long-term economic growth. It is truly indefensible that the existing tax code -- with its depreciation schedule that does not allow taxpayers to write off the full cost of their investments -- discourages businesses from reinvesting earnings.

Mr. Chairman, while this seemingly esoteric portion of the Contract gets little attention, it is absolutely critical that we enact it and allow American businesses to continue to grow.

I thank you all very much for being here today and look forward to your testimony.

Chairman ARCHER. Our first witness this morning is the architect of the neutral cost recovery provision as proposed in the Contract With America. We are pleased to have our colleague, Hon. Nick Smith of Michigan before the committee.

As you probably are aware, under the rules of this committee and I think most other committees, we ask you to keep your verbal presentation to 5 minutes or less, and you may submit your entire written statement to be printed in the record without objection.

Nick, we are glad to have you with us, and you may proceed.

STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. SMITH OF MICHIGAN. Mr. Chairman, members of the committee, thank you very much. With your permission, I will submit for the record my written testimony and respond more specifically to the three concerns that were raised. Also I would like to insert in the record the answer to the question on cost, if that is appropriate, on neutral cost recovery.

Chairman ARCHER. Without objection, so ordered.

Mr. SMITH OF MICHIGAN. Mr. Chairman, I would like to include one other item for the record, and I will talk about it, a chart showing why neutral cost recovery is not a tax shelter, that reviews old ADR, ACRS, GDS, and the proposed system of neutral cost recovery showing specifically that those tax writeoffs under neutral cost recovery are less than any of the previous formations that we put in our Tax Code.

Chairman ARCHER. Without objection.

Mr. SMITH OF MICHIGAN. Let me just give some background and my specific interest. I come from a State, the only State in the Nation that has a total expensing for all business property. So in Michigan we have a value-added tax that allows a full writeoff in the first year for the purchase of all machinery, equipment and facilities.

It has been suggested to me that I should sort of not just increase the expensing to $25,000, but if we could increase that expensing allowance to $250,000 and then have less neutral cost recovery, it would be even a greater advantage to us.

In this country we are facing a situation where our savings are less than most of the other countries of the world, where our investment in machinery and equipment are less than most other industrialized countries, and ultimately and not surprisingly the rate of increase in our productivity is also next to the bottom of the G–7 countries.

We are seeing countries, the Asian tigers, Singapore, Hong Kong, South Korea, and Taiwan, as well as the other industrialized countries, are doing whatever they can to attract capital investment. Economists agree that the countries that are able to attract capital investment are the ones that are going to expand their economies the most.

That is what we are not doing in this country. We saw the Wall Street Journal this morning which said wages are going down. Our standard of living in this country is going down. The question we must ask ourselves is, what can we do in Federal policy to start turning that around.

Right now, ladies and gentlemen of this committee, we penalize businesses that decide they want to invest in the machinery, equipment and facilities that are going to increase their productivity. Does it increase productivity? Being a farmer from Michigan, my analysis would be that if you put a better tool in the hands of the American worker, that worker is going to be able to increase his efficiency, ultimately his productivity, and in the final analysis our competitive position in a very tough world market.

The world market is getting tougher, we have to build the kind of items that people want to buy at a competitive price. The way to do that is to have the kind of tools and equipment necessary.

I introduced this bill last year with about 100 bipartisan cosponsors. This year it has been reintroduced as H.R. 199 and it is part of the Contract With America. It is the only specific job growth proposal in our Contract With America.

I hope the committee will seriously look at it. The Treasury testified the other day that it was going to cost something like $122 billion, an average of $11 billion a year for the next 10 years. Dynamic analysis says to the contrary, it is going to bring in much more revenue than that.

I would suggest, and some of the expert witnesses that are following me will verify this statistically, that even if the economy grows just a very small fraction of what the dynamic model estimates, we will compensate for even the static estimate of costs of this specific proposal.

The other day in Budget Committee, I asked Alan Greenspan, Chairman of the Federal Reserve, what we should do when the static cost of a proposal is significant. His answer was essentially that good policy is good policy, and Congress can't decide what is good for America based simply on a static cost estimate that isn't going to be exact. Mr. Chairman, I appreciate the opportunity to testify, and I would be glad to answer any questions.

Thank you very much.

[The prepared statement and attachment follow:]

NICK SMITH, MEMBER OF CONGRESS
Testimony on Neutral Cost Recovery
before the House Ways and Means Committee
January 26, 1995

MR. CHAIRMAN...MEMBERS OF THE WAYS AND MEANS COMMITTEE, NEUTRAL COST RECOVERY IS THE ONLY SPECIFIC JOB GROWTH INCENTIVE IN THE CONTRACT WITH AMERICA. CAPITAL GAINS TAX RELIEF WOULD HELP BUSINESSES WHEN THEY SELL MACHINERY, EQUIPMENT AND FACILITIES. NEUTRAL COST RECOVERY IS AN INCENTIVE TO MAKE THESE CAPITAL PURCHASES IN THE FIRST PLACE. LIKE CAPITAL GAINS INDEXATION, NEUTRAL COST RECOVERY INDEXES DEPRECIATION SCHEDULES FOR INFLATION. UNDER OUR TAX CODE, BUSINESSES HAVE TO WAIT 5, 10, 15, OR EVEN 20 YEARS BEFORE DEDUCTING THE PURCHASE PRICE, WHILE INFLATION ERODES THE VALUE OF THE DEDUCTION.

THE U.S. TRAILS ITS INTERNATIONAL COMPETITORS IN PRODUCTIVITY GROWTH. NEUTRAL COST RECOVERY ADDRESSES THIS BY PUTTING MORE EFFICIENT EQUIPMENT AND MACHINERY IN THE HANDS OF OUR WORKERS. THIS IMPROVES PRODUCTIVITY AND ULTIMATELY CREATES JOBS AND INCREASES WAGES FOR AMERICAN WORKERS. SIMPLY PUT, A PERSON WITH BETTER TOOLS PRODUCES MORE EFFICIENTLY AND EARNS MORE MONEY. WE CAN PUT MORE AND BETTER TOOLS IN THE HANDS OF OUR WORKERS BY ESTABLISHING A FAIR TAX POLICY, ONE THAT TAXES THE <u>REAL</u> RETURN ON CAPITAL BY NEUTRALIZING THE LOSS FROM INFLATION AND THE TIME VALUE OF MONEY.

TO ENCOURAGE BUSINESSES TO INVEST IN MACHINERY AND EQUIPMENT, WE NEED TO ALLOW THEM TO DEDUCT THE COSTS OF THESE PURCHASES AS BUSINESS EXPENSES IN THE YEAR OF PURCHASE OR AN EQUIVALENT VALUE AS DEPRECIATION IN LATER YEARS. IN THE SERVICE INDUSTRY SECTOR, WE ALLOW NEARLY ALL PURCHASES TO BE EXPENSED. IN MANUFACTURING AND PRODUCTION INDUSTRIES THAT MOST NEED THE NEW EQUIPMENT AND FACILITIES TO COMPETE IN THE WORLD MARKET, WE DENY THE FULL DEDUCTION.

MR. CHAIRMAN...MEMBERS OF THE COMMITTEE, AS YOU KNOW, THE MARKET FOR CAPITAL IS AN INTERNATIONAL ONE. IN OUR POST COLD WAR ECONOMY, OTHER COUNTRIES ARE DOING EVERYTHING THEY CAN TO ATTRACT CAPITAL INVESTMENT, AND MANY ARE SUCCEEDING. LOOK AT THE GROWTH OF THE NEWLY INDUSTRIALIZED COUNTRIES OF SOUTHEASTERN ASIA: SOUTH KOREA, HONG KONG, TAIWAN, AND SINGAPORE. IN CHINA AS WELL, THE GROWTH RATE HAS BEEN REMARKABLE. CLEARLY, THE U.S. NO LONGER HAS A MONOPOLY ATTRACTING CAPITAL INVESTMENT. IN FACT, OVER THE LAST 20 YEARS, THE UNITED STATES HAS TRAILED MOST OF OUR INDUSTRIALIZED COMPETITORS IN CAPITAL INVESTMENT PER WORKER, IN PART BECAUSE OTHER COUNTRIES HAVE MORE FAVORABLE TAX POLICIES. A STUDY DONE BY THE AMERICAN COUNCIL ON CAPITAL FORMATION, FOUND THAT U.S. CORPORATE TAX DEPRECIATION RULES PUT US AT A STRONG DISADVANTAGE WITH OUR COMPETITORS. OBVIOUSLY, COUNTRIES WITH TAX LAWS THAT ENCOURAGE INVESTMENT GIVE THEMSELVES AN ADVANTAGE IN ATTRACTING CAPITAL.

WE CAN ATTRACT MORE CAPITAL INVESTMENT, INCREASE PRODUCTIVITY, AND EXPAND JOB OPPORTUNITIES SIMPLY BY BEING FAIR TO BUSINESSES WHICH MAKE LONG-TERM INVESTMENTS. NEUTRAL COST RECOVERY, WHICH I SPONSORED IN THE LAST CONGRESS AS H.R. 539 WITH 91 BIPARTISAN COSPONSORS, WAS REINTRODUCED ON THE FIRST DAY OF THIS SESSION AS H.R. 199. THIS PROPOSAL HAS BEEN ENDORSED BY LEADING BUSINESS ORGANIZATIONS: THE U.S. CHAMBER OF COMMERCE, THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS, AND THE NATIONAL BUSINESS OWNERS ASSOCIATION. THESE GROUPS UNDERSTAND THAT OUR CURRENT TAX TREATMENT FOR EQUIPMENT, MACHINERY, AND FACILITIES IS NOT FAIR AND PUTS OUR BUSINESSES AT A COMPETITIVE DISADVANTAGE WITH OTHER COUNTRIES. MOST ECONOMISTS AGREE THAT ENCOURAGING CAPITAL INVESTMENT IS KEY TO ECONOMIC AND JOB EXPANSION.

<u>WE DISCOURAGE CAPITAL INVESTMENT IN THIS COUNTRY BECAUSE WE DON'T ALLOW THESE PURCHASES TO BE CONSIDERED A BUSINESS EXPENSE</u>. TO GIVE A RELATIVELY SIMPLE EXAMPLE, LET'S SAY A BUSINESS BUYS A $10,000 MACHINE WITH AN EXPECTED LIFE OF TEN YEARS. THE BUSINESS CAN DEPRECIATE IT OVER TEN YEARS AT $1,000 PER YEAR UNDER OUR CURRENT TAX LAWS. ASSUMING JUST 3% INFLATION, THE ANNUAL DEDUCTION IS WORTH ONLY $766 BY THE TENTH YEAR, INSTEAD OF THE ORIGINAL $1,000.

UNDER THIS NEUTRAL COST RECOVERY BILL, BUSINESSES WOULD BE ALLOWED TO "EXPENSE" OR "DEDUCT" THE FIRST $25,000 OF CAPITAL INVESTMENT IN THE YEAR OF PURCHASE AND INDEX OTHER DEPRECIATION FOR INFLATION. NEUTRAL COST RECOVERY WOULD BE AN OPTIONAL DEPRECIATION METHOD, SO BUSINESSES COULD STILL CHOOSE TO USE EXISTING FORMS OF DEPRECIATION IF THEY WANTED THE LARGER UP-FRONT DEDUCTION. I WOULD LIKE TO MENTION THAT THE CURRENT 200% DECLINING BALANCE AND THE 150% ARE ARBITRARY METHODS OF DEPRECIATION. THIS, ALONG WITH THE ARBITRARY YEARS OF LIFE ASSIGNED BY THE DEPARTMENT OF TREASURY, RESULT IN SIGNIFICANT TAX ADVANTAGES TO CERTAIN BUSINESSES.

NEUTRAL COST RECOVERY IS NOT ARBITRARY AND ALLOWS ALL BUSINESSES TO DEDUCT THE FULL PRESENT VALUE OF THE PURCHASE REGARDLESS OF THE YEARS OF LIFE. THIS LEGISLATION WOULD USE THE GROSS DOMESTIC PRODUCT DEFLATOR, COMPUTED BY THE COMMERCE DEPARTMENT, TO DETERMINE THE INFLATION INDEX. THOSE BUSINESS PURCHASES NOW ELIGIBLE FOR 200% DECLINING BALANCE WOULD BE ELIGIBLE TO CHOOSE NEUTRAL COST RECOVERY AT 150% DECLINING BALANCE AND WOULD HAVE THE INDEX INCREASED BY A FACTOR OF 1.035 TO REFLECT THE TIME VALUE OF MONEY.

NEUTRAL COST RECOVERY WOULD REDUCE THE COST OF MACHINERY AND FACILITIES, INCREASING ECONOMIC ACTIVITY BY AN ESTIMATED $3.5 TRILLION BY THE YEAR 2000 ACCORDING TO AN INDEPENDENT STUDY BY GARY AND ALDONA ROBBINS. GARY ROBBINS IS A FORMER REVENUE ESTIMATOR FOR THE DEPARTMENT OF TREASURY. EACH MEMBER OF THE COMMITTEE HAS BEEN PROVIDED WITH A COPY OF THIS STUDY. I WOULD REFER MEMBERS OF THE COMMITTEE TO THE CHARTS ON PAGES SEVEN AND TEN OF THE STUDY WHICH SHOW THAT FULL NEUTRAL COST RECOVERY WOULD CREATE AN ESTIMATED 2.7 MILLION NEW JOBS AND INCREASE ANNUAL TAKE HOME PAY BY AROUND $3,300 OVER THE NEXT FIVE YEARS. NEUTRAL COST RECOVERY RESULTS IN EXPANDED BUSINESS AND JOBS BECAUSE IT REDUCES THE COST OF MACHINERY, EQUIPMENT, AND FACILITIES BY AN ESTIMATED 16%.

ON JANUARY 10TH, A REPRESENTATIVE FROM THE ADMINISTRATION SUGGESTED THAT NEUTRAL COST RECOVERY WOULD LEAD TO A REVENUE LOSS AVERAGING $11 BILLION PER YEAR OVER THE NEXT 11 YEARS. THIS ESTIMATE WAS MADE USING A STATIC MODEL. UNDER THE DYNAMIC MODEL USED BY GARY ROBBINS, NEUTRAL COST RECOVERY WOULD INCREASE REVENUES BY APPROXIMATELY 119 BILLION DOLLARS OVER THE NEXT FIVE YEARS. WHILE WE HAVE DECIDED TO CONTINUE THE USE OF STATIC SCORING FOR BUDGET PURPOSES, I WOULD SUGGEST THAT ECONOMISTS AGREE THAT LOWERING THE COST OF MACHINERY, EQUIPMENT, AND FACILITIES BY INDEXING DEPRECIATION FOR INFLATION WILL EXPAND THE ECONOMY AND JOBS. IF THERE IS ONLY TEN PERCENT OF THE ECONOMIC EXPANSION THAT THE DYNAMIC MODEL PREDICTS, REVENUES COMING INTO THE FEDERAL GOVERNMENT WILL MORE THAN OFFSET THE $120 BILLION COST PREDICTED BY TREASURY.

I'D LIKE TO FINISH BY MENTIONING FEDERAL RESERVE BOARD CHAIRMAN ALAN GREENSPAN'S TESTIMONY BEFORE OUR HOUSE BUDGET COMMITTEE TWO WEEKS AGO. HE REMINDED US THAT GOOD POLICY IS GOOD POLICY. I WOULD LIKE TO SUBMIT PART OF HIS STATEMENT FOR THE RECORD. HE SAID THAT IT IS "PROBABLY WISE TO GO FORWARD WITH THOSE (IMPORTANT) POLICIES (THAT HAVE GREAT POTENTIAL) AND TAKE THE SCORING HITS..."

LADIES AND GENTLEMEN OF THE COMMITTEE, AS A MEMBER OF THE BUDGET COMMITTEE, I'M 100% COMMITTED TO CUTTING THE DEFICIT, AND I BELIEVE THAT THIS PROPOSAL WILL HELP, NOT HINDER THAT EFFORT. THIS PROPOSAL WILL BRING IN REVENUE, BOTH IN THE SHORT RUN AND IN THE LONG RUN. EVEN UNDER THE STATIC MODEL, IT WILL BRING IN ADDITIONAL REVENUE OVER THE FIRST SIX YEARS. THERE IS NO QUESTION IN MY MIND THAT BY TIME WE REACH THE SEVENTH YEAR, INCREASED ECONOMIC ACTIVITY WILL HAVE KICKED IN AND PRODUCED MORE THAN ENOUGH NEW REVENUE TO COVER ANY LOSSES.

MR. CHAIRMAN...MEMBERS OF THE COMMITTEE, I WOULD LIKE TO THANK YOU AND THE COMMITTEE FOR YOUR EFFORTS, AND WOULD BE HAPPY TO ANSWER ANY QUESTIONS.

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Neutral Cost Recovery: Investing for Growth, Not Planning for Taxes

Problems with Tax Depreciation

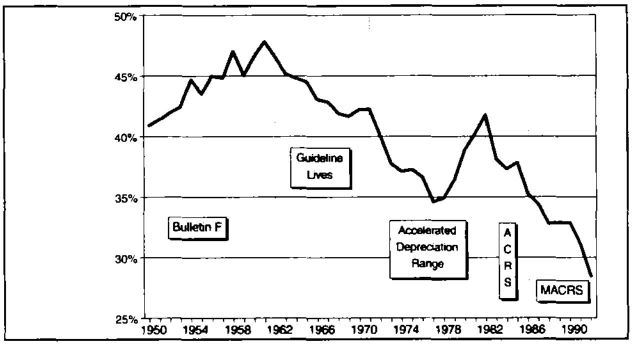
Tax depreciation specifies how much of the original cost of an asset a business can deduct from income in a particular year. (See the Appendix for a discussion of the current depreciation rules.) There are four major ways in which the current tax depreciation system can adversely affect the mix of assets and the level of the U.S. stock of capital.

1. Inherent time bias

Current depreciation schedules are biased against longer-lived assets because future deductions are worth less than current deductions. An investor faced with a choice between a $1 deduction today versus $1 tomorrow would always choose today. At the very least, $1 taken today could be put in the bank and earn interest. Moreover, the erosion in value gets worse the longer the deduction is delayed.

In response to this bias, the mix of U.S. capital has moved toward shorter-lived assets. During the 1950s and early 1960s, structures composed roughly 40 to 50 percent of fixed nonresidential investment. Today, however, structures make up only 28 percent [See Figure 1]. While some of this decline may be due to technological and other reasons, part of it is tied to the tax depreciation system.

Figure 1
Investment in Longer-Lived Assets and Tax Depreciation Schedules



2. Tax life errors

Economic depreciation is the rate at which an asset wears out or becomes obsolete. Recovery of economic depreciation is the largest single cost of most assets. *Tax* depreciation, on the other hand, is an artificial construct which specifies in law the rate at which the original cost of an asset can be deducted from income for tax purposes. Because economic depreciation depends on market conditions and technology, it can never coincide with tax depreciation. Inevitable errors made in determining the appropriate tax lives of assets lead to an inefficient mix of capital and become permanent impediments to growth.

3. Political influence

Tax lives and depreciation schedules are determined through the political process. Government tax analysts usually set "appropriate" tax lives and the Congress generally sets depreciation schedules. The potential for political influence opens the system to abuse.

4. Inflation

Depreciation deductions are not indexed for inflation. This shortcoming magnifies the bias generated by the other three problems.

Table 1 shows how these problems reduce the value of depreciation deductions. In a world with no inflation, failure to adjust for the normal rate of return reduces the value of depreciation deductions by 5.9 percent for a 5-year asset, by 8.4 percent for a 7-year asset and by 44.9 percent for a 39-year asset. To overcome this loss in value, longer-lived assets must earn a considerably higher return over their lifetimes. This higher return is equal to the loss in depreciation value times the tax rate. For example, assuming a tax rate of 33 percent, a 39-year asset would have to earn 13 percent more than a 5-year asset simply due to the lower value of depreciation deductions.

Higher inflation magnifies the loss in value. At a 10 percent inflation rate, the total loss in depreciation deductions ranges from 19.4 percent for a 5-year asset to 80.3 percent for a 39-year asset.

Table 1

Loss in Value of Depreciation Write-Offs

Inflation	5-Year Life	7-Year Life	39-Year Life
0%[1]	5.9%	8.4%	44.9%
3%	10.5%	14.7%	63.2%
5%	13.3%	18.4%	70.4%
10%	19.4%	26.4%	80.3%

[1] Represents the loss due to failure to adjust for the normal, real aftertax rate of return on capital.

Neutral Cost Recovery as a Solution

An alternative is to move toward a cost recovery system which assures that all types of capital are treated in exactly the same manner. Expensing has long been an academic model for the perfectly neutral tax system. Expensing allows the business to deduct the entire cost of a new investment immediately. Under current law, small businesses can expense only $17,500 in capital acquisition costs in any year.

Transition problems, however, have always been the basis for rejecting this approach. First, expensing would result in an immediate tax write-off of all investment, completely wiping out most business taxes. The revenue loss would be prohibitive with today's budget deficits. Furthermore, some businesses would not have enough taxable income to use the expanded depreciation deductions, as happened in 1982 when the Accelerated Cost Recovery System (ACRS) was put into place.

H.R. 539, The Investment Tax Incentive Act

Representative Nick Smith (R-MI) has introduced "The Investment Tax Incentive Act" (H.R. 539). The bill would reduce the taxation of capital by reforming the cost recovery system for depreciable assets. Reduced taxes on capital would lower the cost of capital, promote capital formation and spur job creation and economic growth.

Provisions of H.R. 539

H.R. 539 would make federal tax depreciation write-offs for equipment and structures *neutral* with respect to inflation and the time value of money. The specific neutral cost recovery provisions of H.R. 539 are as follows:

- Allow businesses to index depreciation for investments in plant and equipment based on the GDP deflator and an annual rate of return of 3.5 percent.
- Limit the method of depreciation to 150 percent declining balance for indexed investments.
- Provide businesses with the option to continue using current law instead of indexing.
- Effective for investments made after December 31, 1994.
- Eliminate the requirement that taxable income under the Alternative Minimum Tax (AMT) be further increased by an amount equal to 75 percent of the difference between 150 percent declining balance and straight-line depreciation.

The practical impact of neutral cost recovery is to provide owners of capital with the equivalent of a $100 billion tax incentive to invest with no short-term revenue loss.

Although the complicated adjustment under the adjusted current earnings (ACE) provision was repealed in 1993, the bill allows businesses to deduct previously denied allowances on a prorated basis over the next five years.

Neutral Cost Recovery offers a benefit equivalent to expensing to business without the undesirable side effects. Although based on the current schedules of tax lives, it would make two adjustments that would remove all four problems with the present system. (See the Appendix for the proposed schedules.) First, allowable deductions would be indexed for inflation. On average, this adjustment would allow investors to maintain their principal at original values by augmenting write-offs to reflect the higher replacement cost of the same investment solely due to inflation.

The second adjustment would allow an investor to recover a normal 3.5 percent rate of return on invested principal. Adjusting for the time value of money puts the value of future deductions on an equal footing with current deductions. Making one arbitrary schedule the same as any other neutralizes the inherent bias among competing assets, errors in effective tax life measurement and political influence.

A third adjustment assures that the revenue effects of the change will be positive in the near term. The new write-off pattern would be based on a slower method—150 percent declining balance versus current law's 200 percent declining balance—for most assets.

Table 2 compares the depreciation deductions for a $50,000 machine under current law and under neutral cost recovery. Assuming a 5-year asset life and 3 percent inflation, the present value of the $50,000 in depreciation deductions under current law is only $44,762. Under neutral cost recovery, the present value of the $57,820 in write-offs would equal the original cost of the machine. If the machine were incorrectly classified as a 7-year asset, the present value of depreciation deductions under current law would fall to $42,644. Such misclassification would not matter under neutral cost recovery, however, because the present value of the $61,643 in deductions would still be $50,000.

The practical impact of neutral cost recovery is to provide owners of capital with the equivalent of a $100 billion tax incentive to invest with no short-term revenue loss. By stretching out the write-offs, future income and tax benefits would be in balance. It would effectively eliminate taxes on the "normal" return to capital. Business taxable income would not go to zero, however, because taxes would still apply to the returns from intangible assets such as patents, goodwill, trade names, market presence, and so forth. Further, because the new depreciation system would be limited to new investments, it would not provide a windfall to existing capital. Taxes would continue to be collected on the return to existing assets as long as they remain in service.

Table 2

Depreciation Write-Offs for a $50,000 Machine: Present Law vs. Neutral Cost Recovery

Year	Schedule	Write-off	Inflation Adjustment[1]	Net Present Value[2]
Current Law, 5-Year Life				
1	0.2000	$ 10,000	$ 10,000	$ 10,000
2	0.3200	16,000	15,534	15,009
3	0.1920	9,600	9,049	8,447
4	0.1152	5,760	5,271	4,754
5	0.1152	5,760	5,118	4,460
6	0.0576	2,880	2,484	2,092
Total	1.0000	$ 50,000	$ 47,456	$ 44,762
Neutral Cost Recovery, 5-Year Life				
1	0.1500	$ 7,500	$ 7,.500	$ 7,500
2	0.2550	13,592	13,196	12,750
3	0.1785	10,143	9,561	8,925
4	0.1666	10,092	9,236	8,330
5	0.1666	10,759	9,559	8,330
6	0.0833	5,735	4,947	4,165
Total	1.0000	$ 57,820	$ 53,998	$50,000
Current Law, 7-Year Life				
1	0.1429	$ 7,145	$ 7,145	$ 7,145
2	0.2449	12,245	11,888	11,486
3	0.1749	8,745	8,243	7,695
4	0.1249	6,245	5,715	5,155
5	0.0893	4,465	3,967	3,457
6	0.0892	4,460	3,847	3,239
7	0.0893	4,465	3,739	3,042
8	0.0446	2,230	1,813	1,425
Total	1.0000	$ 50,000	$ 46,358	$ 42,644
Neutral Cost Recovery, 7-Year Life				
1	0.1071	$ 5,355	$ 5,355	$ 5,355
2	0.1913	10, 197	9,900	9,565
3	0.1503	8,541	8,050	7,515
4	0.1225	7,421	6,791	6,125
5	0.1225	7,911	7,029	6,125
6	0.1225	8,433	7,275	6,125
7	0.1225	8,990	7,529	6,125
8	0.0613	4,796	3,900	3,065
Total	1.0000	$ 61,643	$ 55,828	$ 50,000

[1] *Assumes 3% inflation*
[2] *Assumes 3.5% normal rate of return*

Economic and Revenue Effects from H.R. 539

The economic and revenue effects of H.R. 539 were estimated using the Fiscal Associates general equilibrium model of the U.S. economy. Simulating the economic effects of the proposal is done in two stages. First, we used the economic assumptions contained in Clinton administration's February budget to produce a *baseline* forecast of future GDP, employment and investment. Next comes a *dynamic* simulation that forecasts how the economy would behave if H.R. 539 were adopted.

Economic Effects of H.R. 539

H.R. 539 would reduce the economy-wide marginal tax rate on capital by 24 percent and lower the cost of capital by 16 percent [See Figure 2]. Tables 3 and 4 show that by the year 2000:

- Higher investment would increase capital formation in the U.S. by $8.9 trillion [See Figure 3].
- This larger stock of U.S. capital would lead to the creation of 2.7 million new jobs [See Figure 4].

Table 3

Changes in the Economy H.R. 539, Neutral Cost Recovery

**Baseline forecast uses economic assumptions contained in Clinton administration's February budget, which assumes real GDP growth of 2.8%, 2.7%, 2.6%, 2.6% and 2.5% for 1995 through 1999, respectively.*

	Percentage Change from Baseline in:*					
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth Rate
1995	-21.6%	-16.1%	1.6%	0.1%	4.2%	1.6%
1996	-22.1%	-16.1%	4.2%	0.5%	11.2%	2.1%
1997	-22.6%	-16.1%	6.7%	0.9%	18.0%	2.2%
1998	-23.0%	-16.1%	8.7%	1.4%	23.3%	2.1%
1999	-23.4%	-16.2%	10.5%	1.9%	27.8%	2.0%
2000	-23.8%	-16.2%	11.4%	2.3%	30.0%	1.8%

Table 4

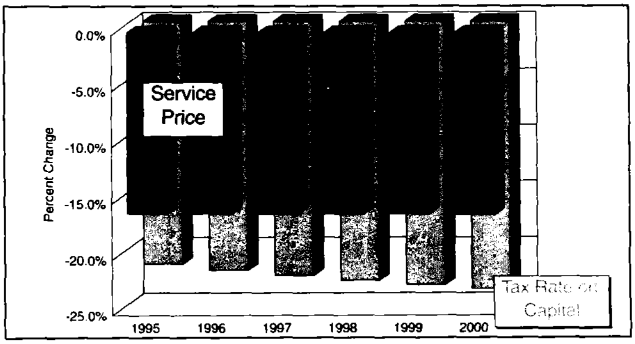
Changes in the Economy H.R. 539, Neutral Cost Recovery

**Baseline forecast uses economic assumptions contained in Clinton administration's February budget, which assumes real GDP growth of 2.8%, 2.7%, 2.6%, 2.6% and 2.5% for 1995 through 1999, respectively.*

	Change from Baseline in:*		
Year	GDP ($bil. Nom.)	Jobs (mil.)	Capital ($bil. Nom.)
1995	101.6	0.157	968.7
1996	286.7	0.539	2,697.5
1997	493.4	1.078	4,571.8
1998	687.4	1.675	6,246.0
1999	878.4	2.252	7,847.0
2000	1,022.1	2.717	8,936.6
1995-2000	3,469.7		

Figure 2

Reduction In The Cost Of Capital & The Marginal Tax Rate On Capital



- More capital and labor would yield an extra $3.5 trillion in gross domestic product between 1995 and 2000. By the year 2000, annual GDP would be $1 trillion higher than otherwise.
- This greater economic activity would boost the long-term annual growth rate by 1.8 percentage points [See Figure 5].

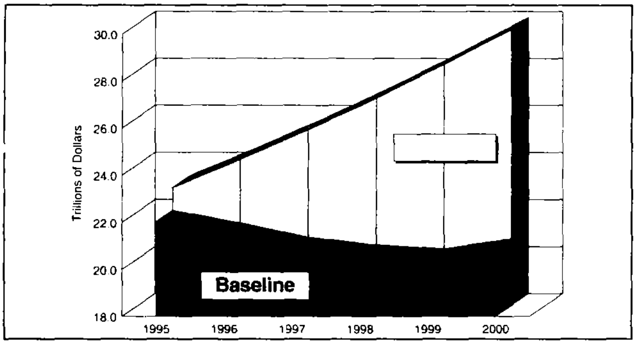


Figure 3
Increase In The Stock Of U.S. Capital

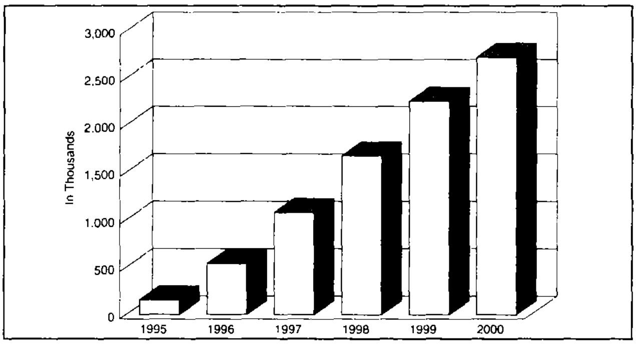


Figure 4
New Jobs From H.R. 539

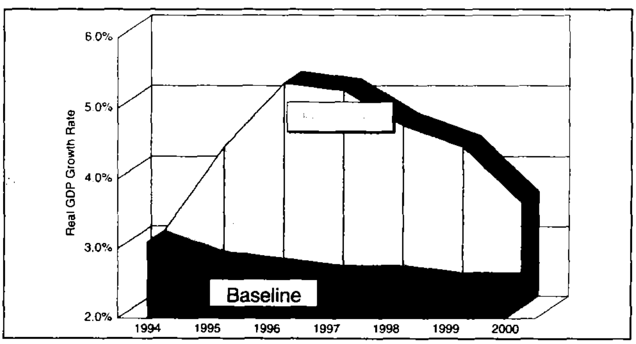


Figure 5
Added Real GDP Growth From HR 539

TaxAction Analysis

Revenue Effects from H.R. 539

H.R. 539 would pick up $1.1 billion in federal tax revenues between 1995 and 2000.

Even on a static basis H.R. 539 would pick up revenue during the early years. This is because the switch from the double-declining method to 150-percent declining balance initially reduces depreciation deductions. Higher depreciation deductions in later years due to indexing adjustments start producing static revenue losses by the fifth year.

By that time, however, added revenues from an additional two percentage points to the long-term U.S. growth path would continue to greatly outweigh any static losses. As Tables 5 and 6 show:

- Even ignoring economic growth effects, H.R. 539 would pick up $1.1 billion in federal tax revenues between 1995 and 2000.
- In addition, higher economic growth would generate an extra $596.1 billion in federal payroll, corporate and personal income, and excise taxes
- As a result, federal revenues would grow by $597.2 billion over 1995 to 2000 [See Figure 6].
- Including higher state and local revenues from added growth means government at all levels would pick up $1 trillion in additional revenue between now and the end of the decade [See Figure 7].

Table 5
Dynamic Revenue Changes
H.R. 539, Neutral Cost Recovery
($bil. nominal)

Year	Federal Soc. Sec. Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Government
1995	8.6	0.4	15.8	1.7	26.4	15.9	42.3
1996	24.2	1.1	23.8	4.2	53.3	36.0	89.4
1997	41.7	2.3	33.3	7.0	84.2	58.9	143.1
1998	58.1	3.8	43.6	9.6	115.2	81.1	196.3
1999	74.2	5.6	53.9	12.3	146.0	103.0	249.0
2000	86.3	7.7	62.5	14.3	170.9	120.1	291.0
1995-2000	293.1	20.9	233.0	49.0	596.1	415.0	1,011.0

Table 6
Revenue Changes
H.R. 539, Neutral Cost Recovery
($bil. nominal)

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1995	1.0	26.4	27.4	43.5
1996	7.6	53.3	60.9	98.9
1997	9.2	84.2	93.4	154.5
1998	4.4	115.2	119.6	201.8
1999	-5.6	146.0	140.4	242.0
2000	-15.4	170.9	155.5	271.8
1995-2000	1.1	596.1	597.2	1,012.5

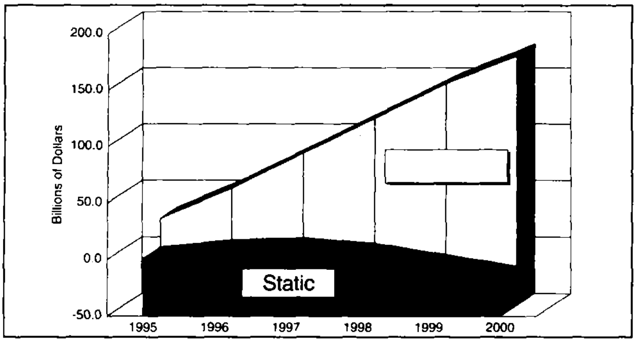


Figure 6

Static vs. Dynamic Revenue Effects from H.R. 539

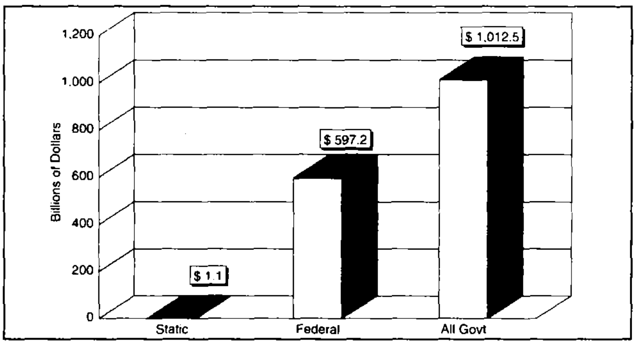


Figure 7

H.R. 539 Cumulative Revenue Effects, 1995-2000

H.R. 539 Would Benefit Workers

H.R. 539 would add 2.7 million jobs to the economy by the year 2000. Furthermore, the almost $9 trillion expansion in the stock of U.S. capital over the same period would raise the productivity and wages of existing workers. As Table 7 shows, that would amount to an average $4,826 more per worker in annual pretax wages and $3,332 more in take-home pay by the year 2000 [See Figure 8].

Moreover, the gains by workers would be many times more than those received by investors. As Table 8 shows, 68 percent of the $1 trillion addition to GDP in the year 2000 would translate into higher income for workers, government and investors. The bulk — 63 percent — would go to workers as higher take-home pay [See Figure 9]. Federal, state and local governments would receive 39 percent of the increase in higher revenues. Investors would actually take a 2 percent loss due to changing asset values. They would be willing to take short-term losses because they expect to recoup and make profits in the future.

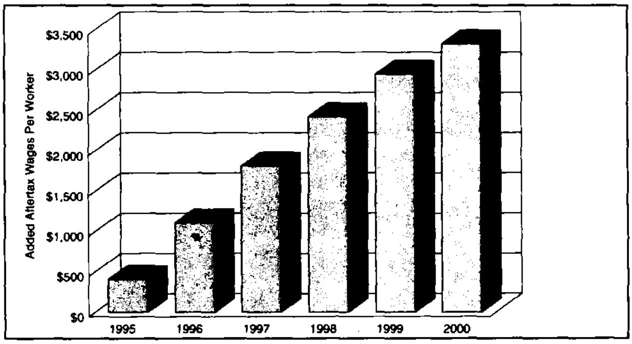
Table 7

Labor Market Effects H.R. 539, Neutral Cost Recovery

Year	Percentage Change in Jobs	Change in Jobs (mil.)	Percentage Change in Aftertax Wage Rate	Change in Aftertax Wage Rate (annual)	Change in Pretax Wage Rate (annual)
1995	0.1%	0.157	1.4%	$ 408	$ 596
1996	0.5%	0.539	3.6%	1,110	1,618
1997	0.9%	1.078	5.6%	1,816	2,641
1998	1.4%	1.675	7.1%	2,425	3,521
1999	1.9%	2.252	8.2%	2,953	4,285
2000	2.3%	2.717	8.8%	3,332	4,826

Figure 8

Increase in Take Home Pay From HR 539



Year	Change in GDP	Change in Capital Consumption Allowances*	Change in National Income	Change in Aftertax Labor Compensation	Change in Government Revenue	Change in Net Aftertax Capital Income**
1995	101.6	34.8	66.8	42.6	43.5	-19.4
1996	286.7	97.6	189.0	120.5	98.9	-30.3
1997	493.4	166.6	326.8	207.9	154.5	-35.6
1998	687.4	229.2	458.3	290.0	201.8	-33.6
1999	878.4	289.8	588.7	370.8	242.0	-24.2
2000	1,022.1	332.0	690.1	432.2	271.8	-13.9
1995-2000	3,469.7	1,150.0	2,319.7	1,464.1	1,012.5	-156.9

Table 8

Composition of Net Changes in Income Flows H.R. 539, Neutral Cost Recovery ($bil. nominal)

*Replacement of capital assets that have worn out or become obsolete.

**Can be negative because it does not account for changes in asset values. Investors may be willing to accept a

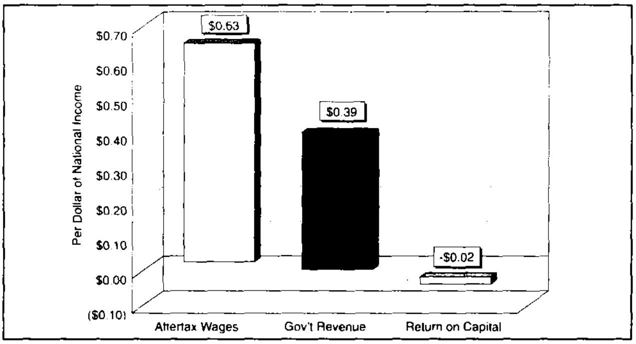


Figure 9

Gains to Labor, Government & Investors From H.R. 539

Conclusion

For policymakers interested in growing the economy and jobs, taking the tax bias out of investment decisions and raising new revenues, Neutral Cost Recovery is a winning combination.

Appendix

Classes of Recovery Property Under MACRS

The Tax Reform Act of 1986 established the Modified Accelerated Cost Recovery System (MACRS) as the basis for depreciating tangible property for tax purposes. The property's "class life" is used in determining the recovery class to which MACRS property belongs. In some cases MACRS arbitrarily assigns certain assets to a specific recovery class regardless of its class life. Property placed in service after May 1993 falls into one of the following MACRS recovery classes;

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- 27.5-year residential rental property,
- 39-year nonresidential real property,
- and 50-year railroad grading or tunnel bore.

The 3-year MACRS recovery class includes depreciable personal property with a class life of 4 years or less, race horses over 2 years old when placed in service by the taxpayer and other horses over 12 years old when placed in service by the taxpayer.

The 5-year MACRS recovery class includes depreciable personal property with a class life of more than 4 years but less than 10 years. In addition, the following property is arbitrarily included in this class;

- automobiles or light-general purpose trucks,
- semi-conductor manufacturing equipment,
- computer-based telephone central office switching equipment (excluding PBX equipment),
- qualified technological equipment,
- research and experimentation property,
- equipment used to produce, distribute, or use electrical energy derived from geothermal deposit,
- certain equipment which can convert ocean thermal energy into electrical or other useful energy,
- certain equipment that converts biomass into a useful form of energy,
- and cargo containers.

The 7-year MACRS recovery class includes depreciable personal property with a class life of more than 10 years but less than 16 years and property which does not have a class life and which is not specifically assigned to any other MACRS class. Also, specifically included in this class are railroad tracks.

The 10-year MACRS recovery class includes depreciable personal property with a class life of more than 16 years but less than 20 years. Single purpose agriculture and horticultural structures and any tree or vine-bearing fruit or nuts is in the 10-year category.

The 15-year MACRS recovery class includes depreciable personal property with a class life of more than 20 years but less than 25 years. This category relates primarily to public utilities and includes municipal wastewater treatment plants and telephone distribution plants and comparable equipment used for 2-way exchange of voice and data communications. The category uses 150 percent declining balance.

The 20-year MACRS includes municipal sewers with a class life of 50 years and property with an ADR midpoint of 25 years or more. MACRS provides 150 percent declining balance over 20 years.

The 27.5-year class for business and residential buildings includes residential rental property, mobile homes, elevators, and escalators. Low-income housing falls into this category. MACRS also applies a straight line write-off.

Most nonresidential real property falls into the 39-year class. This includes most structures used by businesses.

Table 9

Current Law General Depreciation Schedules, Half-Year Convention

Year	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	27.5-Year	39-Year
1	0.3333	0.2000	0.1429	0.1000	0.0500	0.03750	0.01818	0.01282
2	0.4445	0.3200	0.2449	0.1800	0.0950	0.07219	0.03636	0.02564
3	0.1481	0.1920	0.1749	0.1440	0.0855	0.06677	0.03636	0.02564
4	0.0741	0.1152	0.1249	0.1152	0.0770	0.06177	0.03636	0.02564
5		0.1152	0.0893	0.0922	0.0693	0.05713	0.03636	0.02564
6		0.0576	0.0892	0.0737	0.0623	0.05285	0.03636	0.02564
7			0.0893	0.0655	0.0590	0.04888	0.03636	0.02564
8			0.0446	0.0655	0.0590	0.04522	0.03636	0.02564
9				0.0656	0.0591	0.04462	0.03637	0.02564
10				0.0655	0.0590	0.04461	0.03636	0.02564
11				0.0328	0.0591	0.04462	0.03637	0.02564
12					0.0590	0.04461	0.03636	0.02564
13					0.0591	0.04462	0.03637	0.02564
14					0.0590	0.04461	0.03636	0.02564
15					0.0591	0.04462	0.03637	0.02564
16					0.0295	0.04461	0.03636	0.02564
17						0.04462	0.03637	0.02564
18						0.04461	0.03636	0.02564
19						0.04462	0.03637	0.02564
20						0.04461	0.03636	0.02564
21						0.02231	0.03637	0.02564
22							0.03636	0.02564
23							0.03637	0.02564
24							0.03636	0.02564
25							0.03637	0.02564
26							0.03636	0.02564
27							0.03637	0.02564
28							0.03636	0.02564
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30								0.02564
31								0.02564
32								0.02564
33								0.02564
34								0.02564
35								0.02564
36								0.02564
37								0.02564
38								0.02564
39								0.02564
40								0.01282

Table 10

Proposed Basic 150% Declining Balance Before Adjustment

Year	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	27.5-Year	39-Year
1	0.2500	0.1500	0.1071	0.0750	0.0500	0.03750	0.02727	0.01923
2	0.3750	0.2550	0.1913	0.1388	0.0950	0.07219	0.05306	0.03772
3	0.2500	0.1785	0.1503	0.1179	0.0855	0.06677	0.05016	0.03627
4	0.1250	0.1666	0.1225	0.1002	0.0770	0.06177	0.04743	0.03488
5		0.1666	0.1225	0.0874	0.0693	0.05713	0.04484	0.03353
6		0.0833	0.1225	0.0874	0.0623	0.05285	0.04239	0.03225
7			0.1225	0.0874	0.0590	0.04888	0.04008	0.03100
8			0.0613	0.0874	0.0590	0.04522	0.03790	0.02981
9				0.0874	0.0591	0.04462	0.03583	0.02867
10				0.0874	0.0590	0.04461	0.03387	0.02756
11				0.0437	0.0591	0.04462	0.03262	0.02650
12					0.0590	0.04461	0.03262	0.02548
13					0.0591	0.04462	0.03262	0.02450
14					0.0590	0.04461	0.03262	0.02356
15					0.0591	0.04462	0.03262	0.02310
16					0.0295	0.04461	0.03262	0.02310
17						0.04462	0.03262	0.02310
18						0.04461	0.03262	0.02310
19						0.04462	0.03262	0.02310
20						0.04461	0.03262	0.02310
21						0.02231	0.03262	0.02310
22							0.03262	0.02310
23							0.03262	0.02310
24							0.03262	0.02310
25							0.03262	0.02310
26							0.03262	0.02310
27							0.03262	0.02310
28							0.03263	0.02310
29								0.02310
30								0.02310
31								0.02310
32								0.02310
33								0.02310
34								0.02310
35								0.02310
36								0.02310
37								0.02310
38								0.02310
39								0.02310
40								0.01154

Table 11

Neutral Cost Recovery (H.R. 539) With Constant 3% Inflation

Year	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	27.5-Year	39-Year
1	0.2500	0.1500	0.1071	0.0750	0.0500	0.0375	0.0273	0.0192
2	0.3998	0.2718	0.2039	0.1480	0.1013	0.0770	0.0566	0.0402
3	0.2841	0.2029	0.1708	0.1340	0.0972	0.0759	0.0570	0.0412
4	0.1514	0.2018	0.1484	0.1214	0.0933	0.0748	0.0575	0.0423
5		0.2152	0.1582	0.1129	0.0895	0.0738	0.0579	0.0433
6		0.1147	0.1687	0.1203	0.0858	0.0728	0.0584	0.0444
7			0.1798	0.1283	0.0866	0.0717	0.0588	0.0455
8			0.0959	0.1368	0.0923	0.0708	0.0593	0.0466
9				0.1458	0.0986	0.0744	0.0598	0.0478
10				0.1554	0.1049	0.0793	0.0602	0.0490
11				0.0828	0.1120	0.0846	0.0618	0.0502
12					0.1192	0.0902	0.0659	0.0515
13					0.1273	0.0961	0.0703	0.0528
14					0.1355	0.1025	0.0749	0.0541
15					0.1447	0.1092	0.0799	0.0566
16					0.0770	0.1164	0.0851	0.0603
17						0.1242	0.0908	0.0643
18						0.1323	0.0968	0.0685
19						0.1411	0.1032	0.0730
20						0.1504	0.1100	0.0779
21						0.0802	0.1172	0.0830
22							0.1250	0.0885
23							0.1332	0.0943
24							0.1420	0.1006
25							0.1514	0.1072
26							0.1614	0.1143
27							0.1721	0.1219
28							0.1835	0.1299
29								0.1385
30								0.1476
31								0.1574
32								0.1678
33								0.1789
34								0.1907
35								0.2033
36								0.2167
37								0.2310
38								0.2463
39								0.2625
40								0.1398

Methodology

The Fiscal Associates Model explicitly incorporates detailed information on tax policy and how it affects the economy, capital investment, output and jobs. Taxes on labor income consist of personal income taxes, payroll taxes and labor's share of indirect business taxes, such as sales and excise taxes. Taxes on capital consist of those levied on assets directly, on the output produced by assets and on the return accruing to owners. The tax treatment for the 20 capital classifications in the Fiscal Associates Tax Model is the average of 5,000 specific assets, weighted by their capital stocks.

We use the service price to measure the cost of capital. The service price of capital relates the components of the investment decision to the supply price of capital. First popularized by Harvard professor Dale Jorgenson, it is based on a multi-period representation of the income and expenses associated with an investment. The expenses associated with an investment are economic depreciation, taxes and the aftertax real rate of return that must be paid to investors.

About the Authors

Gary Robbins is President of Fiscal Associates, a Washington D.C.-based economic consulting firm, and Senior Research Associate of TaxAction Analysis. Mr. Robbins has developed a general equilibrium model of the U.S. economy that specifically incorporates the effects of taxes and government spending. He was Chief of the Applied Econometrics Staff at the U.S. Treasury Department from 1981 to 1982, and Assistant to the Director of the Office of Tax Analysis from 1976 to 1981. Recent publications include IPI Policy Report #124: *Putting Capital Back to Work for America*, and IPI Policy Report #111: *Playing Politics with Government Forecasts.* Mr. Robbins' articles and analysis frequently appear in the financial press. He received his master's degree in Economics from Southern Methodist University.

Aldona Robbins, Vice President of Fiscal Associates and Senior Research Associate of TaxAction Analysis, has extensive experience with public and private retirement programs. As senior economist in the Office of Economic Policy, U.S. Department of the Treasury from 1979 to 1985, Dr. Robbins' performed staff work for the Secretary in his capacity as Managing Trustee of the Social Security trust funds. Recent publications include IPI Policy Report # 115: *Promoting Growth Through Tax Policy*, and IPI Policy Report #119: *Taxes, Spending and Deficits: The Crisis in Government Finance.* She received a master's degree and doctorate in Economics from the University of Pittsburgh.

About TaxAction Analysis

TaxAction Analysis is the tax policy arm of the Institute for Policy Innovation, a non-profit, non-partisan public policy organization. TaxAction Analysis recognizes that changing tax policy affects incentives to work, save, and invest. These changes in economic behavior are frequently ignored in static government forecasts, resulting in policy decisions that negatively affect economic growth, capital formation, employment, and local, state, and federal revenues. TaxAction Analysis publishes **Economic Scorecard**, a quarterly newsletter, as well as additional commentary on tax policy.

Nothing written here should be construed as necessarily reflecting the views of the Institute for Policy Innovation, or as an attempt to aid or hinder the passage of any bill before Congress.

Chairman ARCHER. Thank you, Mr. Smith. We appreciate your testimony this morning.

Mr. Gibbons.

Mr. GIBBONS. I don't really have a question for you, Mr. Smith. I just want to call to the committee's attention that the Chairman of the Federal Reserve has warned us that we better be careful about what we do, that to the extent that we throw more purchasing power in the hands of the consumer right now, at this particular moment, we are flirting seriously with inflation.

The Chairman of the Federal Reserve testified yesterday, as you know, Mr. Smith, before the Senate and said that we face imminent inflation, that we are at maximum capacity utilization of our farms and factories, we are at full employment on the employment side, that the prices of raw materials are beginning to rocket, go up very fast, and that he has received word that suppliers are planning to increase prices.

It would seem to me that we must be extremely cautious here in this committee and in this Congress about what we do about stimulating that inflation. It would seem to me that the best economic policy we could follow at this time would be to calm down the inflationary trend that we are just entering, and not to throw more purchasing power out there to further inflame the market.

All these tax ideas are wonderful, but I think we have a greater responsibility, and that is to make sure that inflation doesn't get loose in this land again. Now, you can say, oh, you can control that by interest rates. Yeah, interest rate control of inflation works real well for the Republican constituencies, but it works terribly on the Democratic controlled constituency. Democrats are people who borrow money to buy their home and buy their car, and I guess some of them unfortunately even use their credit cards for those things, and Republicans by and large mainly, as I observe them, are people who lend the money, and they have gotten a 30 percent return on their interest rates in the last year.

How much further are we going to go? It seems to me that when you kick off a round of inflation and you control it with interest rates, the people who get screwed are the Democrats and the people who make all the money are the Republicans, and maybe that is a little partisan, but just stop and think about it. Most Democrats are not in the money lending business; most of the moneylenders in my community in the Nation are Republicans, and so they love to control inflation by increasing interest rates, and they take it out of the hide of our Democratic constituency. So I think we are really talking about the wrong subject here today.

Mr. SMITH OF MICHIGAN. Mr. Gibbons, I agree with a great deal of what you say, but one solution probably is to have less Federal Government spending out there driving up the prices of what consumers would otherwise——

Mr. GIBBONS. If we can't pay off this deficit at a time of full employment and full utilization of industrial capacity, that should be our primary goal, not tinkering around the edges of this thing trying to figure out more ways of putting more money in the hands of consumers. That is what most of this tax reduction is all about.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. I congratulate my colleague from Michigan on his testimony. Having had the privilege of visiting with him at his home in the past, and knowing the success he had before coming to Congress in the real world, I salute him for his efforts to try and stimulate investment in plant and equipment with a view to increasing productivity and creating more jobs.

I was intrigued by the testimony of our colleague, Mr. Gibbons, about the difference between Republicans and Democrats. The thing that intrigues me is I think on his side of the aisle they do like to spend, there is no question about that, and they have done it to the point that we are faced with a looming prospect shortly after the turn of the century of a national debt totaling $7 trillion. The fact of the matter is, that money is productively spent only when it is left in the private sector.

Second, the interest rates and so forth that we are going to have to pay to try and keep financing and rolling over that debt are calculated, I think, to destroy the world's last best hope. It is the private sector that provides the resources, and frankly I believed for years that businesses shouldn't be taxed at all because they don't pay taxes. Taxes are a cost of doing business and they have got to be passed on to you and me as consumers with a fair return on investment or you are out of business. So anything that lightens the load for those people engaged in producing goods and services for the benefit of one and all, I applaud, and I salute my colleague again for his initiative here. Keep up the good fight.

Chairman ARCHER. May I ask the members of the committee who wish to inquire to raise their hands. OK.

Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman. I, too, congratulate my colleague, Nick Smith from Michigan, for his constructive ideas on how to make our private sector more productive.

I would like to take just a minute to comment about my good friend, Sam Gibbons', remarks. For 40 years this Federal Government has spent and spent out of control, and if there is any reason to look any further than that, you can look right in this very room, from our predecessors who sat at this very table, and established the tax policies of this government to raise the money to spend ourselves into a $5 trillion national debt.

I can't believe after 40 years of one party rule in the House that now we are trying to get a handle on the Federal deficit. For the first time in my career in the House, it is very short, it is only in its fifth term, we are now, without a discharge petition, openly debating a balanced budget amendment to the Constitution on the floor of the House of Representatives without forcing it out onto the floor and having a balanced budget amendment actually have a chance to pass. We need that kind of fiscal discipline that has not been here for 40 years, and I congratulate you, Nick, because this is one of the ideas that can make our private sector more productive; it can make job creation a lot easier. We will have more people participate and have the Federal Government out of the business of trying to provide and stimulate the economy. It is the private sector's job to do that and not the Federal Government's job; and, I congratulate you on your ideas. I will be very supportive of them when we talk about them and bring them to a vote in this committee.

Thank you.

Mr. SMITH OF MICHIGAN. Thank you.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. I wanted to welcome my colleague from Michigan, and I admire your tenacity. You did give me a copy of Dr. Greenspan's testimony on how we estimate these proposals, and I read his later comments as you gave them to me, but I also went back and looked at his earlier testimony, and I simply wanted to say I am sorry Mr. Bunning has left, that I hope we will take his warning, Dr. Greenspan and others, seriously.

I think Mr. Bunning's comments rewrite or try to rewrite history. The 1981 act was not the act of a partisan, a Democratic government. It was an initiative of a Republican President, and I simply want us not to make the same mistakes in the nineties that I think were made on a bipartisan basis in the early eighties, and we will make those mistakes if we ignore warnings about what revenue proposals will cost.

I mean, the Treasury Department estimates that over 10 years your proposal would cost $120 billion at a time when we have a debt that is approximating or coming closer and closer to $5 trillion, and I don't think we can go through a process that imagines away the problem of the debt and the deficit and says let's put on rose colored glasses and assume that these proposals will make money instead of losing, will diminish the deficit instead of increasing it, so I very much again respect your tenacity.

I think the problems of economic growth are very, very serious ones. I favor proposals that stimulate economic growth. As I said yesterday, the issue is not just that of distribution of the tax burden, there are issues of growth. But under the banner of economic growth, we are going to make a serious mistake if we adopt proposals that lead to an increase in the national debt and burgeoning deficits. So I don't know if you want to respond to that, but at some point you and everybody else are going to have to wrestle with estimates that your proposal will dig our hole deeper. And that I think was the basic note sounded by Dr. Greenspan, by Paul Volcker, and virtually everybody else who testified before the Budget Committee that day.

Mr. SMITH OF MICHIGAN. Mr. Chairman, if I may briefly respond, it seems to me there are two questions. One is, do businesses react based on the way we structure our Tax Code? I think the answer is absolutely yes. Businesses often operate to minimize the negative effect of taxes rather than to maximize their efficiency and productivity.

The second question is on cost, and it is a serious question. I'd like to suggest you look at this analysis of the bill by Gary and Aldona Robbins which predicts a dramatic increase in economic activity that will go to $3 trillion by the year 2000, increase the number of jobs for workers by 3 million and increase take-home pay by $3,500.

If only a very small fraction of this actually happens, if we were only to have two-tenths of 1 percent growth in the economy because of this kind of change that stimulates business to invest in property, it would more than pay the $121 billion cost estimated by Treasury.

Mr. LEVIN. But just remember we heard that song before in the early eighties, and it turned out to have a lot of sour notes, and I just urge that we learn from the past.

Thank you very much.

Chairman ARCHER. I will announce to the members that I have on my list for inquiry Mr. Zimmer and Mr. Cardin, and at that point, we will move on to our next panel.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman. I want to commend Mr. Smith for getting this proposal included in the Contract With America. I think it focuses on a very important deficiency in the current Tax Code, but I would like to ask you a specific question.

Is there any reason, Congressman Smith, why you included this fairly complex writeoff system—neutral cost recovery—rather than do what your State of Michigan has done, which is to provide 100 percent expensing immediately, except for the scoring impact?

Mr. SMITH OF MICHIGAN. No reason.

Mr. ZIMMER. So essentially you want to get us as close as you could to 100 percent expensing without knocking the revenue estimates——

Mr. SMITH OF MICHIGAN. Mr. Zimmer, the other partial reason is to allow some flexibility with some companies that would like the option of spreading out some of that cost over several years so beginning companies and startup companies that don't have the revenue to be offset by a first-year depreciation, could take the deduction in later years.

Mr. ZIMMER. In the longest run, beyond 5 or 10 years or any arbitrary cutoff date, do you see the economic impact of your proposal being substantially different from the impact of 100 percent expensing in terms of the impact on economic growth and in terms of the impact on revenues through the dynamic process?

Mr. SMITH OF MICHIGAN. Certainly it would be a greater advantage, and a greater stimulant to expand production in the economy if we did have expensing with some flexibility to spread it out over several years for those companies with low income.

Mr. ZIMMER. Do you have any idea whether using a static model with a very long horizon, a time horizon, the 100 percent expensing would come out essentially the same as the neutral cost recovery?

Mr. SMITH OF MICHIGAN. No, I don't, but Dale Jorgenson, who is going to follow me, and Ernest Christian, Stephen Entin, Thomas Usher, and Andrew Sigler could be more definitive in answering that. If you spread out the static model and said here is what this legislation is going to cost, it would cost more if you spread it out far enough. The static model might even say it is going to cost more than the whole Nation is worth collectively.

The problem is that a static model doesn't take into consideration that a business changes its actions based on tax policy. That's why we should look at our depreciation schedules. We are behind the curve compared with what other countries are doing to their businesses, so I would be delighted if we could go to more expensing.

Mr. ZIMMER. I appreciate your candor on that. I think we shouldn't twist ourselves up in knots simply to fit ourselves into some kind of preconceived formalistic context that has been set up by the budget process if we in the long run don't achieve any benefit to the taxpayer or the economy by doing so.

Thank you very much.

Mr. SMITH OF MICHIGAN. Thank you.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. Mr. Smith, thank you for your testimony. I think you have identified a real problem. I just disagree with your solution to the problem.

Depreciation has presented problems for businesses, and I have had many who have come to visit me to talk about concerns that they have, not one supporting the neutral cost recovery, but many suggesting that the AMT problems are the most important issues that we need to deal with.

I will be filing legislation that will use the regular tax recovery periods for AMT for I think that is a better approach than the neutral cost recovery at this time. I am just curious as to your views on the AMT problems as they relate to depreciation and whether you would recommend that we look at that also.

Mr. SMITH OF MICHIGAN. I would ask where we would get the biggest bang for our buck. The manufacturers, the businesses that I have talked to that are somewhat wary of neutral cost recovery, their real concern is this Congress might change the rules midstream, but if we——

Mr. CARDIN. Which I would suggest has happened before, and if in fact Treasury's revenue estimates of $120 billion were to become reality, I think it is likely that Congress would change the rules some time within the next 10 years.

Mr. SMITH OF MICHIGAN. We have never in history, to my knowledge, changed the rules of a depreciation schedule midstream. Once you start on a depreciation schedule, you have always been allowed to follow that schedule.

Mr. CARDIN. We could change rates.

Mr. SMITH OF MICHIGAN. That is certainly a possibility. Let me just briefly reflect on the AMT. Businesses I have talked to feel that we should just reduce tax rates and make it easier for us to stay in business.

It seems to me that if we want to get the biggest bang for our buck, we need to design a tax system that is going to have the kind of results that are going to be good for the American economy. If you agree that encouraging the purchase of new tools, equipment, and facilities is good for the economy and for ultimate productivity, then it seems to me that that is where we want to direct our stimulus. We need to reward what we want to encourage.

Mr. CARDIN. And I applaud you for that. The individuals who will make those judgments, though, are the businesses and the people who run the businesses, and it is just interesting to me that the people that I have talked to in the business community have told me that they would rather us deal with AMT than with the proposal that you have brought forward.

They are the individuals who are going to have to have the confidence to go out there and risk their dollars to buy the investments that we are talking about.

Shouldn't we be listening to what they think is best?

Mr. SMITH OF MICHIGAN. Yes, that's what we're doing. The U.S. Chamber of Commerce, NFIB, and the National Business Owners Association have all endorsed this. I would suspect the majority of the businesses that are members have endorsed this because they think it is important. They don't like being put at a competitive disadvantage with businesses in other countries, but it is certainly something to explore with the business community as they testify.

Mr. CARDIN. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Smith.

Mr. SMITH OF MICHIGAN. Mr. Chairman, members, thank you for your consideration.

Chairman ARCHER. If we could ask our next panel to be seated at the witness table.

A general and very warm welcome to each one of you. We are interested in hearing your views primarily on the neutral cost recovery provisions that are in the Contract With America, and our first witness will be Dr. Jorgenson, or Professor Jorgenson, with the Department of Economics at Harvard University.

Mr. Jorgenson, you may proceed. Maybe I should reiterate again for the benefit of all of you that under the rules of the committee, we will ask you to limit your verbal presentation to 5 minutes or less. The lights that are in the center of the witness table will be green, yellow, and red. When the red light comes on, the 5 minutes is up.

I am not going to cut any of you off in the middle of your sentences, but we would appreciate your cooperation. If you have a longer statement in writing, it will be put in the record in its entirety, without objection.

Mr. Jorgenson, you may proceed.

STATEMENT OF DALE W. JORGENSON, FREDERIC EATON ABBE PROFESSOR, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY; AND DIRECTOR OF PROGRAM ON TECHNOLOGY AND ECONOMIC POLICY, KENNEDY SCHOOL OF GOVERNMENT

Mr. JORGENSON. Mr. Chairman, ladies and gentlemen of the committee, it is a very great privilege for me to testify before you today on the neutral cost recovery system that you have just heard about from Congressman Smith.

I would like to begin with a summary of my conclusions. As the Chairman just suggested, I am going to avail myself of the opportunity to submit a written version of the testimony that will provide support for these conclusions.

Today we have heard a great deal of discussion of the matter of the Federal deficit, and I think that is a very relevant consideration, but I would like to submit to this committee that the problem of closing the gap between revenues and expenditures is not due to political gridlock and it is not due to ineptitude. It is due to slow economic growth.

If you look at each of the measures that have been adopted by this Congress, and we have had the tax reform decade of the eighties, just past, each one of those provisions was accompanied by forecasts of the type that the Treasury has brought forward and has been the subject of remarks at this hearing.

In every case the economic growth of this economy was inadequate to produce the revenues that were projected, and therefore it is very important for us to focus on the cause of our fiscal problems, namely deficient economic growth. Tax policy, which is of course the major concern of this committee, is the critical instrument for stimulating U.S. economic growth. That is something I think all of us can agree on.

Investment is the most important source of economic growth. Therefore to deal with the core problem that we confront, which is the deficiency in economic growth, we need to focus in future tax reform on measures that are going to strengthen rather than weaken the growth of this economy.

In testimony that I presented to this committee 2 years ago, I supported the position that the Tax Reform Act of 1986, the most recent major tax reform to come out of this Congress, had a very substantial positive impact on U.S. economic growth. That was the result of eliminating a large number of special tax provisions for specific types of assets, resulting in much greater neutrality in the treatment of different kinds of capital income.

As a result, the efficiency of capital allocation within our economy has improved and new opportunities for growth have been created. The benefits of the 1986 Tax Act have steadily increased as the rate of inflation has declined, and I currently estimate these benefits to be in the order of magnitude of $1.25 trillion.

In other words, the benefits are roughly the same order of magnitude as the Federal budget is projected to be by the end of this century.

I would now like to turn to the neutral cost recovery system, which is the subject of these hearings. As Congressman Smith has told you and Mr. Zimmer has emphasized, the neutral cost recovery system is equivalent from the taxpayers' point of view to expensing—immediate expensing of investment expenditures. Therefore, it would further enhance the neutrality of capital income taxation that was substantially advanced in the 1986 Tax Reform Act.

However, to be important as a stimulus to economic growth, it is very important to combine this tax reform with an elimination of deductions such as the deductions to taxpayers who choose to finance investment through debt rather than equity. Otherwise, the Treasury would be put into the position of subsidizing investments by taxpayers.

Therefore I conclude that the way that this committee should look at the neutral cost recovery system is that it is an important element in the transition to a system of taxation which is based on consumption rather than on income, and within that context, it seems to me that it is a proposal that is based on well-tested economic ideas and can serve as an appropriate starting point for the development of tax reform legislation.

Thank you, Mr. Chairman.

[The prepared statement follows:]

CAPITAL COST RECOVERY AND THE
AGENDA FOR U.S. TAX REFORM
by
Dale W. Jorgenson

1. Introduction.

My name is Dale W. Jorgenson. I am Frederic Eaton Abbe Professor of Economics at Harvard University and Director of Program on Technology and Economic Policy at the Kennedy School of Government. I have written extensively on the topic of capital income taxation, most recently in my Brookings Institution volume, edited with Ralph Landau, TAX REFORM AND THE COST OF CAPITAL: AN INTERNATIONAL COMPARISON, published a little over one year ago. It is a privilege for me to testify to the Committee on Ways and Means today on neutral cost recovery. I will begin by summarizing my conclusions:

Slow economic growth, rather than political gridlock or ineptitude, underlies that failure of attempts by successive Administrations and the Congress to tame the federal deficit. Tax policy for saving and investment is the critical instrument for stimulating U.S. economic growth, since investment is the most important source of growth. To revive our lagging growth rate, future tax reform should focus on strengthening rather than weakening the thrust of the Tax Reform Act of 1986.

The federal tax system imposes a very substantial loss in opportunities for growth on the U.S. economy, but this burden was considerably reduced by the 1986 Tax Act. By eliminating a number of special tax provisions for specific types of assets this landmark legislation resulted in much greater neutrality in the taxation of income from capital. This has substantially increased the efficiency of capital allocation within our economy and created new opportunities of economic growth. The benefits of the 1986 Tax Act have steadily increased as the rate of inflation has declined.

The Neutral Cost Recovery Act of 1995 would provide deductions for depreciation that would further enhance neutrality in capital income taxation. These deductions would be based on the recovery of capital cost over the lifetime of an asset, as under current tax law. However, the deductions would be increased annually to compensate for inflation and allow for a return on capital of three and a half percent per year. From the point of view of the taxpayer these depreciation deductions would be equivalent to an immediate write-off of capital cost or "expensing" of capital expenditures.

In a 1977 study, *Blueprints for Tax Reform*, the U.S. Treasury proposed two alternative approaches to shifting the federal tax base from income to consumption. The first of these is a value added tax, like that employed in Europe and Japan. The second would eliminate investment from the tax base by permitting taxpayers to treat investment expenditures as a business expense. Since investment would be excluded from the tax base, all other deductions from capital income, such as deductions for interest expenses, would also be eliminated.

The Neutral Cost Recovery Act of 1995, like the Treasury proposal of 1977, would eliminate investment from the tax base. To shift the tax base from income to consumption it is essential to eliminate all other deductions from capital income at the same time, including the deduction for interest expenses. Otherwise, the U.S. Treasury would be put in the position of providing subsidies in the form of tax deductions to taxpayers who choose to finance investment through debt rather than equity.

The neutral cost recovery depreciation adjustment should be regarded as one component of a tax system based on consumption rather than income. Shifting the federal tax base from income to consumption would create very important new opportunities for U.S. economic growth. I estimate that the benefits would amount to two trillion dollars. This is the present value of the increase in the future standard of living of U.S. taxpayers that would result from a shift from income to consumption as a base for the federal tax system.

The traditional objection to a consumption tax is that it would be regressive rather than progressive, falling disproportionately on low income taxpayers. Two alternative proposals have been developed for overcoming this objection. the Nunn-Domenici "consumed income" tax proposal and the Armey "flat tax" plan. Under these proposals a system of exemptions for individual taxpayers would be introduced to provide the requisite degree of progressivity in the federal tax system. These proposals are based on well-tested economic ideas and can serve as an appropriate starting point for the development of tax reform legislation.

2. The 1986 Tax Reform

As the tax policy debate revives, it is essential to concentrate on fundamental issues. My paper deals with two of them: First, what did we achieve and fail to achieve with the Tax Reform Act of 1986? Second, how can we create new opportunities for future U.S. economic growth through tax reform? I can summarize my main conclusions succinctly: The U.S. tax system imposes a very substantial loss in efficiency on the economy, but this burden was considerably reduced by the Tax Reform Act of 1986. The benefits of this landmark legislation has steadily increased as the rate of inflation has declined.

My second conclusion is that tax burdens still differ substantially among alternative tax programs, so that very significant opportunities for U.S. economic growth can be created through tax reform. One approach to tax reform would "level the playing field" between business assets and owner-occupied housing by sharply curtailing the tax benefits to housing provided through deductions for mortgage interest and state and local property taxes. A second approach to tax reform would shift the federal tax base from income to consumption by excluding investment from the tax base. Both approaches would substantially enhance the growth of our future standard of living.

I will support my conclusions by first reviewing the achievements of the 1986 tax reform. The economic impact of the 1986 reform was positive and substantial at rates of inflation like those prevailing before the current economic downturn. As the rate of inflation declines toward zero, the benefits grow to the equivalent of more than a whole year of federal spending. This was a major contribution to the future growth of the U.S. economy. However, the 1986 Tax Act did not go far enough in broadening the tax base and eliminating tax preferences. The goal of tax reform should be once again to reduce marginal tax rates at the individual level below thirty percent.

I have presented supporting evidence for my findings about the effect of inflation on the economic impact of tax policy in Table 1, which is taken from my 1990 paper with Kun-Young Yun, published in the *Journal of Political Economy*. In this table we compare the 1986 Tax Act with the pre-existing 1985 Tax Law and two tax reform proposals advanced by the Treasury and the President. Each of these two proposals involved indexing the tax structure for inflation. Table 1 presents estimates of the growth opportunities created or destroyed by inflation and the alternative tax reform packages; all estimates are in billions of 1987 dollars. The benchmark for the comparison is the 1985 Tax Law at a six percent inflation rate.

Let me try to be precise in defining the meaning of the term "growth opportunities". From the economic perspective the objective of government policy, including tax policy, is to enhance the standard of living of U.S. consumers now and in the future. The concept of growth opportunities is a summary of increases in our future standard of living that result from tax policy. This summary measure is simply the present value of these increases in the standard of living to U.S. households. It represents the willingness of the present generation of taxpayers to pay for a change in tax policy that will affect their own standard of living and that of future generations of taxpayers.

As a benchmark for comparison of alternative tax policies, we require that all changes in tax policy are revenue neutral, that is, revenue and expenditure of the government are the same. We adjust tax revenues to maintain the budgetary position of the government sector by means of a purely hypothetical "lump-sum" tax. We consider three alternative methods for adjusting government revenues that involve changes in tax induced distortions. These involve proportional changes in taxes on labor income, sales taxes on investment and consumption goods, and taxes on income from both capital and labor.

Turning to the impact of the 1986 Tax Act, we see that the 1986 tax reform with inflation at the benchmark rate of six percent produces a sizable gain in opportunities for future economic growth. For the distorting revenue adjustments, these gains range from $746.9 billion 1987 dollars to $999.4 billions, or nearly a trillion dollars, equivalent to almost a year's federal spending. The Tax Reform Act of 1986 obviously generated very substantial growth

Table 1.
Growth Opportunities Created by the 1986 Tax Reform
(Billions of 1987 Dollars)

Rate of Inflation	Revenue Adjustment	1985 Tax Law	Treasury Proposal	President's Proposal	1986 Tax Act
0%	Lump Sum Tax	724.0	1489.6	1691.4	1561.8
	Labor Income Tax	478.2	1468.8	1642.4	1565.0
	Sales Tax	400.3	1452.9	1614.6	1558.7
	Individual Income Tax	374.5	1456.1	1619.1	1563.1
6%	Lump Sum Tax	0.0	1907.6	2452.2	448.4
	Labor Income Tax	0.0	1711.4	2170.4	746.9
	Sales Tax	0.0	1600.1	2104.9	901.2
	Individual Income Tax	0.0	1595.8	2007.9	999.4
10%	Lump Sum Tax	-477.1	2060.4	3015.6	-200.8
	Labor Income Tax	-333.7	1791.6	2584.7	267.3
	Sales Tax	-285.2	1623.5	2356.4	517.0
	Individual Income Tax	-221.9	1604.8	2353.1	748.6

Note: In 1987, the national wealth (beginning of the year) was $15,920.2 billion dollars.

opportunities for the U.S. economy. Tax policy makers should recognize the 1986 reform as a giant step in the right direction.

If we compare the Treasury and President's proposals with the 1986 Tax Act at a six percent inflation rate, we find that these proposals would have produced much greater gains in growth opportunities – more than double those of the 1986 Tax Act for the President's proposal and better than fifty percent more for the Treasury proposal. The obvious question is, why? Fortunately, this complex question has a simple answer: indexing! At a zero inflation rate the two proposals and the actual 1986 tax legislation would have had very similar economic impacts, resulting in gains in growth opportunities of one and a half trillions.

The purpose of the exercises that I have just described is to compare actual tax reform proposals with the Tax Reform Act of 1986. The current tax structure retains many of the features that resulted from the 1986 reform. While the economic impact of the 1986 tax reform was positive and sizable, it is important to underline the conclusion that growth opportunities created by the reform expand considerably as the inflation rate declines. This is due to the fact that provisions for capital income taxation were not indexed for inflation.

I have provided further perspective on the 1986 tax reform in Table 2, giving the economic impact of hypothetical tax reforms that could have been adopted in 1986. Yun and I have considered eight alternatives, using the 1985 Tax Law with a six percent inflation rate as our benchmark. These hypothetical reforms focus on tax distortions induced by differences in the tax treatment of income from corporate, noncorporate, and household sectors, and short-lived and long-lived assets. In the parlance of the 1986 tax debate, these are different ways of "leveling the playing field". As before, we maintain the level of government spending and revenues and adjust tax rates to preserve the balance.

The first hypothetical reform eliminates distortions among assets, but leaves distortions among sectors unaffected. The second removes distortions between corporate and noncorporate business, but does not alter other distortions, while the third extends this treatment to the household sector. The fourth "levels the playing field" among assets in corporate and noncorporate sectors, while the fifth extends this treatment to the household sector as well. The sixth reduces taxation on corporate assets to those of noncorporate assets by "corporate tax integration", as proposed by the Treasury's 1992 report, *Taxing Business Income Once*.

I would like to focus attention on the seventh tax reform proposal presented in Table 2. This is the consumption tax scheme proposed in the Treasury's 1977 *Blueprints for Tax Reform* and now embodied in the Nunn-Domenici "consumed income" tax proposal. Under these proposals the tax base for the federal tax system would be shifted from income to consumption by excluding investment from the tax base. The eighth is a more thorough-going version of this scheme that eliminates sales taxes on investment goods. Either of these two tax reform proposals would create very substantial future growth opportunities for the U.S. economy.

The introduction of consumption tax rules for recovery of the cost of investment expenditures would have doubled the gains in U.S. economic growth that resulted from the 1986 Tax Act. This is the consequence of "leveling the playing field" among all economic sectors – households, noncorporate businesses, and corporations. At the same time income from all different types of assets – plant, equipment, inventories, and land – would be treated symmetrically under the tax law. The tax treatment of income from all the assets employed in the U.S. economy would be completely neutral under a consumption tax, like that embodied in *Blueprints* or the Nunn-Domenici proposal.

The Neutral Cost Recovery Act of 1995 embodies one important component of consumption tax rules, namely, the exclusion of investment from the tax base. However, to achieve the same effect as a full-blown consumption tax, this proposal would have to be combined with other tax reforms, including the exclusion of interest expenses as a deduction from business income. Otherwise, the elimination of investment from the tax base combined with deductions for interest expenses would produce subsidies for taxpayers would choose to finance investments through debt rather than equity.

An important advantage of consumption tax rules is that income from capital employed in the household sector, such as owner-occupied residual housing, would be treated symmetrically with income from capital employed by corporate and noncorporate businesses. An alternative approach to neutral treatment of all forms of capital income would be to try to include income from owner- occupied residential housing in the federal tax base. However, this would require such politically unpalatable measures as reducing or totally eliminating such popular tax deductions as the home mortgage interest deduction or deductions for state and local property taxes on owner-occupied residential property.

Table 2.
Growth Opportunities Created by "Leveling the Playing Field"
(Billions of 1987 dollars)

	1985 Law
1. Within Sector Interasset Distortion	
Lump Sum Tax Adjustment	443.9
Labor Income Tax Adjustment	248.1
Sales Tax Adjustment	168.7
Individual Income Tax Adjustment	70.2
2. Intersector Distortion: C and NC Sectors	
Lump Sum Tax Adjustment	-93.3
Labor Income Tax Adjustment	-416.7
Sales Tax Adjustment	-523.8
Individual Income Tax Adjustment	-715.5
3. Intersector Distortion: All Sectors	
Lump Sum Tax Adjustment	2262.6
Labor Income Tax Adjustment	2156.9
Sales Tax Adjustment	2118.6
Individual Income Tax Adjustment	2067.[illegible]
4. No Tax Distortion: C and NC Sectors, All Assets	
Lump Sum Tax Adjustment	326.4
Labor Income Tax Adjustment	69.7
Sales Tax Adjustment	-29.1
Individual Income Tax Adjustment	-16[illegible].7
5. No Tax Distortion: All Sectors, All Assets	
Lump Sum Tax Adjustment	2663.7
Labor Income Tax Adjustment	2603.4
Sales Tax Adjustment	2572.4
Individual Income Tax Adjustment	2547.2
6. Corporate Tax Integration	
Lump Sum Tax Adjustment	1313.1
Labor Income Tax Adjustment	493.4
Sales Tax Adjustment	238.1
Individual Income Tax Adjustment	-274.5
7. Consumption Tax Rules (Zero Effective Tax Rates)	
Lump Sum Tax Adjustment	3853.9
Labor Income Tax Adjustment	2045.4
Sales Tax Adjustment	1749.3
Individual Income Tax Adjustment	2045.4
8. Consumption Tax Rules (Zero Effective Tax Rates) No Sales Tax on Investment Goods	
Lump Sum Tax Adjustment	4128.1
Labor Income Tax Adjustment	1988.0
Sales Tax Adjustment	1722.1
Individual Income Tax Adjustment	1988.0

3. *Directions for Future Tax Reform.*

I next provide a more precise assessment of opportunities to contribute to the future growth of the U.S. economy through tax reform. For this purpose I will draw on a second paper, "The Excess Burden of U.S. Taxation", that I published with Yun in 1991. In this paper we link tax induced losses in economic efficiency directly to U.S. economic growth. We use a nondistorting tax system as a benchmark in measuring the loss in efficiency from taxation. In this tax system all revenue is raised by purely hypothetical taxes that do not distort private decisions and involve no efficiency loss. By focusing on differences in losses among alternative tax programs, we identify promising avenues for future reform.

Our first conclusion is that the loss in efficiency imposed on the U.S. economy by the current tax system is very large. The efficiency loss is equivalent to eighteen percent of government tax revenue. Each dollar of tax revenue costs the private sector a dollar of foregone investment or consumption and an additional loss in growth opportunities of eighteen cents. We call this estimate the *average excess burden*, defined as the gain in efficiency that would result from replacing the whole U.S. tax system by a nondistorting system. Let me hasten to emphasize that this replacement is purely hypothetical.

The concept of efficiency loss most relevant to tax reform is the *marginal excess burden*. The marginal excess burden of the U.S. tax system is defined in terms of the efficiency loss *per dollar* for the final dollar of revenue raised. The marginal excess burden enables us to quantify one of the most familiar propositions in tax policy analysis. Since efficiency losses rise as tax burdens increase, the marginal cost of raising tax revenue is much greater than the average cost. We estimate that the marginal efficiency loss is 39.1 cents per dollar of revenue, more than double the average loss.

Most important, large differences in marginal excess burdens among different tax programs remain. For example, the marginal cost of raising a dollar through taxes on capital income at the individual level is one dollar and 1.7 cents, while the cost of raising a dollar from labor income taxes is only 37.6 cents. For every dollar of tax revenue transferred from capital income to labor income, the U.S. economy *gains* 64.1 cents in future growth opportunities. This transfer would be revenue neutral, so that it would be in perfect conformity to the Clinton Budget Plan. This provides a clear indication of important potential gains in future U.S. economic growth through tax reform.

My paper with Yun describes the efficiency costs of various parts of the U.S. tax system in greater detail. For this purpose, we analyze the growth of the U.S. economy under reductions of tax rates for the following nine components of the U.S. tax system: (1) the corporate income tax; (2) capital income taxes at the individual level, including taxes levied on noncorporate capital income and taxes on individual capital income originating in the corporate sector; (3) property taxes on corporate, noncorporate, and household assets; (4) capital income taxes at both corporate and individual levels; (5) labor income taxes; (6) capital and labor income taxes; (7) the individual income tax; (8) sales taxes on consumption and investment goods; and (9) all taxes.

Table 3 presents the average and marginal efficiency costs of all components of the U.S. tax system under the Tax Reform Act of 1986. The marginal efficiency costs of the whole U.S. tax system in the ninth panel of Table 3 show that the marginal efficiency cost at rates prevailing under the 1986 tax act was .391 so that the loss in efficiency for each dollar of tax revenue raised was 39.1 cents. However, the average efficiency cost for the whole tax system was .180, so that replacing all taxes by a nondistorting tax would have increased opportunities for economic growth by an average of 18 cents per dollar of tax revenue.

The marginal efficiency cost of sales taxes given in the eighth panel of Table 3 was .262 after the reform, while the cost of property taxes given in the third panel was .176. By contrast, the marginal efficiency cost of all income taxes given in the sixth panel of Table 3 was .497. The efficiency losses were 49.7 cents per dollar of income tax revenue, only 17.6 cents per dollar of property tax revenue, and only 26.2 cents per dollar of sales tax revenue. A substantial increase in efficiency could have been realized by reducing income tax rates and increasing the rates of sales and property taxes. We conclude that the Tax Reform Act of 1986 did not successfully overcome the excessive reliance of the U.S. tax system on income taxes.

The structure of the income tax itself is completely out of balance with marginal efficiency costs of labor income taxes at .376, individual capital income taxes at 1.017, and corporate income taxes at .448. Very substantial gains in efficiency could have been realized by further reductions in marginal tax rates on individual and corporate taxes on capital income, even at the expense of increases in marginal tax rates on labor income. Considerable gains in growth opportunities for the U.S. economy could have resulted from reduced reliance on individual income taxes on capital income and more reliance on corporate income taxes.

An important priority for future tax reform is to lessen the dependence of the U.S. tax system on income taxes. Second, within the income tax there is excessive reliance on taxes on capital income at the individual level. Taxes on capital income at both corporate and individual levels are too burdensome, relative to taxes on labor income. Every dollar transferred to labor income taxes from capital income taxes at the individual level costs the U.S. economy 64.1 cents in lost growth opportunities. Reversing the direction of the 1986 reform by raising marginal rates for "high income" taxpayers in the Budget Enforcement Act of 1990 and the Omnibus Budget Reconciliation Act of 1993 has substantially increased the tax burden on capital income.

4. *Conclusion.*

My overall conclusion is that changes in tax rates for upper income taxpayers in 1990 and 1993 has nullified many of the growth opportunities for the U.S. economy created by the Tax Reform Act of 1986. It is important to underline this conclusion, since the recent emphasis on "soaking the rich" increases reliance on capital incomes taxes relative to those on labor income. This will be enormously costly in terms of future opportunities for growth of the U.S. economy. Future tax reforms should strengthen rather than weaken the basic thrust of the 1986 Tax Act in enhancing the neutrality of capital income taxation.

The Neutral Cost Recovery Act of 1995 is an important contribution to the coming debate over tax reform. This Act would introduce provisions for recovery of capital costs that are equivalent to the expensing of investment expenditures required under consumption tax rules. However, neutral cost recovery must be combined with other tax reforms, such as the elimination of deductions for interest expenses, in order to enhance neutrality of the federal tax system. Achieving neutrality in the taxation of income from all assets in the U.S. economy is the most important goal for future tax reform.

Changing the federal tax base from income to consumption is an idea whose time has come. This change will create very important new opportunities for growth in the standard of living of all Americans. The traditional objections to consumption as a base for taxation on grounds of regressiveness have been successfully addressed in the Nunn-Domenici "consumed income" and the Armey "flat tax" reform proposals. A neutral system for cost recovery is embodied in both of these proposals as well as the Neutral Cost Recovery Act of 1995. These proposals are based on well tested economic ideas and can serve as the starting point for the development of tax reform legislation.

Table 3.
Efficiency Costs of U.S. Tax Revenues After the Tax Reform Act of 1986

Tax Bases		Reduction in Tax Rates (%)										
		5	10	20	30	40	50	60	70	80	90	100
1. Corporate Income	MEC	.448	.435	.418	.397	.379	.363	.348	.334	.322	.310	.301
	AEC	.448	.442	.431	.421	.412	.404	.397	.391	.384	.379	.374
2. Ind. Cap. Income	MEC	1.017	.989	.951	.904	.853	.812	.767	.727	.688	.650	.613
	AEC	1.017	1.003	.977	.953	.928	.906	.884	.863	.842	.822	.803
3. Property Value	MEC	.176	.174	.171	.168	.164	.160	.157	.153	.149	.145	.142
	AEC	.176	.175	.173	.171	.169	.168	.166	.164	.162	.160	.158
4. All Cap. Income	MEC	.675	.650	.616	.573	.533	.498	.466	.435	.407	.382	.359
	AEC	.675	.663	.640	.619	.600	.582	.566	.551	.537	.524	.512
5. Labor Income	MEC	.376	.358	.333	.303	.276	.253	.237	.216	.201	.190	.183
	AEC	.376	.367	.350	.334	.320	.307	.296	.285	.275	.266	.259
6. 1+2+5 = 4+5	MEC	.497	.462	.414	.355	.301	.254	.212	.175	.142	.114	.091
	AEC	.497	.480	.448	.418	.391	.366	.343	.323	.304	.287	.271
7. Ind. Income	MEC	.520	.490	.449	.396	.349	.305	.265	.229	.196	.167	.140
	AEC	.520	.505	.477	.451	.426	.403	.381	.361	.342	.325	.308
8. Sales Value	MEC	.262	.259	.254	.249	.242	.236	.230	.224	.218	.211	.205
	AEC	.262	.261	.257	.254	.251	.248	.245	.242	.239	.236	.232
9. All Tax Bases	MEC	.391	.356	.308	.249	.197	.151	.113	.082	.063	.048	.040
	AEC	.391	.374	.342	.312	.285	.260	.238	.220	.204	.190	.180

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Chairman ARCHER. Thank you, Mr. Jorgenson.

Our second witness is Ernest Christian, who a couple of years back was with the Department of the Treasury, and who is now chief counsel for the Center for Strategic Tax Reform. We welcome your testimony. You may proceed.

STATEMENT OF ERNEST S. CHRISTIAN, CHIEF COUNSEL, CENTER FOR STRATEGIC TAX REFORM

Mr. CHRISTIAN. Mr. Chairman, Mr. Gibbons, members of the committee, I attach special significance to the combination of the neutral capital cost recovery system, the American dream savings account, and the capital gains tax reform.

Together these proposals embody important principles of tax policy that serve the national interest. It is that interest and those principles that are vital. The details can be handled one way or another. I recommend to you a statement attributed to Dwight Eisenhower in 1956. He said, "I have but one yardstick by which I measure all major decisions, and that yardstick is, is it good for America."

The philosophical and analytical principles of NCRS and the American dream savings account are good for America. NCRS and ADS are based on the correct analytical principle that income should be taxed once, not twice. Either tax the income that is saved and invested and do not tax the return, or deduct the amount invested and tax the return, but do not tax both the investment and the return.

Although NCRS is not, in my opinion, a full substitute for first-year expensing, it does implicitly recognize that expensing the cost of business capital investment is correct, both as a matter of tax analytics and rational economic policy. Although the American dream savings account is not a full substitute for a full up front deduction for all personal savings, it recognizes that a deduction for saving is the correct rule under a tax system that seeks to tax all income once and the same and not to penalize those who choose to save part of their income for their own and the Nation's benefit.

NCRS, ADS, and capital gains tax reform reflect many of the worthy precepts of neutrality and income measurement that underlie most of the major proposals for totally restructuring the American tax system. As one who has devoted a good portion of his professional career in the Treasury Department and in private life to fundamental restructuring, I applaud the recognition of these precepts.

The present Internal Revenue Code is not good for America. Total restructuring is needed. NCRS and other provisions in the Contract are, in my view, steps toward that goal. Many people anticipate that a total restructuring will soon occur. Many of the reservations about NCRS that you may hear from witnesses probably reflect that expectation.

NCRS is being compared to an ideal standard. Compared to present law, NCRS is meritorious and deserves serious consideration. NCRS is, however, not perfect. Because NCRS postpones present deductions in exchange for larger deductions in the future, it is complex. For the same reason, it may involve an element of uncertainty and risk from a business' standpoint. It results in a pattern of near term revenue gains and larger future revenue losses that may complicate the transition to the kind of total tax restructuring that I understand will soon be on the agenda and that I hope will soon be enacted into law.

If a near-term transitional alternative is sought, one alternative is to accelerate depreciation under present law and to modify the so-called alternative minimum tax accordingly. In the near term this would reduce, but not eliminate, the tax bias against capital investment. That would be good for America.

This near-term relief would also aid the transition to first-year expensing under a total restructuring in the future that is also good for America. On the other hand, compared to present law, NCRS over a long term is also good for America. Thus, the choice is between one or more good things, not a choice between bad and good.

That concludes my oral statement, Mr. Chairman. I thank the committee for its attention.

[The prepared statement follows:]

STATEMENT OF
ERNEST S. CHRISTIAN
CHIEF COUNSEL, CENTER FOR STRATEGIC TAX REFORM
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JANUARY 26, 1995

RE: NEUTRAL COST RECOVERY SYSTEM

In General

In the context of addressing the Neutral Cost Recovery System,[1] I shall also refer to two related tax provisions in the Contract With America now before the Committee -- the capital gains tax reform[2] and the American Dream Savings Account.[3]

I attach special, even historic, significance to the combination of these proposals. They embody important principles of tax policy that serve the national interest.

In making your decision on the details of NCRS and the related provisions, I recommend to you a statement attributed to Dwight Eisenhower in 1956.

> "I have but one yardstick by which I measure all major decisions -- and that yardstick is: Is it good for America?"

Present law penalizes the savings and investment that make labor more productive and provide better jobs and higher livings standards for all Americans. That economic engine is the ultimate source of everyone's income and well-being. To impair that productive process is not good for America; nor is it necessary.

NCRS would reduce, by some measures even eliminate, the tax bias against business capital investment in the future. Other provisions in H. R. 9 and H. R. 6 would reduce but not eliminate the tax penalty on Americans' abilities to save for their own and the nation's future. That is good for America.

It is also good for America that NCRS and other provisions in the Contract reflect many of the same worthy precepts of tax neutrality, correct income measurement, efficiency, and unabashed national self-interest that underlie most of the major proposals for fundamental restructuring of the American tax system that we hear so much about. As one who has devoted a good portion of his professional career, in the Treasury Department and in private life, to fundamental tax restructuring, I applaud the recognition of these precepts. We are moving in the right direction.

Although it goes about it in an indirect and complex way, NCRS implicitly recognizes that expensing the cost of business capital investment is the correct result, both as a matter of tax analytics and rational economic policy.

Both NCRS and the ADS personal savings proposal are based on the correct premise: tax income once but not twice. When a dollar of income is deferred through savings and investment, either do not tax the dollar when invested and tax the return of principal and the earnings on principal when later received, or tax the dollar invested and do not tax the earnings, but do not tax both the dollar and the earnings on the dollar.

True expensing of business capital investment, where the dollar is deducted at the outset, is the ideal. It is the approach taken in Congressman Armey's

[1] H. R. 9, Title II, Job Creation and Wage Enhancement Act of 1995.
[2] H. R. 9, Title I, Job Creation and Wage Enhancement Act of 1995.
[3] H. R. 6, Sec. 4, American Dream Restoration Act.

restructuring proposal and in the restructuring proposal by Senators Domenici and Nunn that has been widely discussed.

NCRS and the ADS personal saving proposal reflect the next best alternative. ADS, for example, is similar to a back-loaded IRA. No deduction is allowed for deposits in the account but the withdrawal of principal and earnings on principal are excluded from tax.

In broad outline, NCRS is the same. A partial deduction is allowed at the outset. Additional and enlarged deductions are allowed later in order to exclude from additional tax a sufficient amount of future returns of principal and earnings on principal to equate to a single tax on a discounted present value basis.

Some may be surprised that I feel it necessary to give such emphasis to one tax instead of two taxes. But remember, a fundamental premise of the present Internal Revenue Code is to tax both the dollar of income that is saved and invested and to tax the earnings on that investment. That is bad for America. The need and opportunity to correct this long-standing failing of present law is what makes NCRS of vital importance.

Detailed Comments on NCRS

Both friends and foes of NCRS may point out deficiencies. Criticisms by proponents of improved capital cost recovery may, however, be muted because they recognize the overriding importance of the principles of NCRS and the great step forward in U.S. tax policy these principles represent.

On the other hand, it is important to correctly understand NCRS. What it is, what it is not, and why. It is also necessary to put NCRS in context.

A. *NCRS Is Not Perfect*

NCRS is not perfect. It is not a full substitute for first-year expensing. It does not eliminate the need to move forward promptly toward the goal of a total restructuring of the American tax system which I hope will be the next item on the Committee's agenda. In some ways, the deficiencies of NCRS highlight the urgent need for a total restructuring of the American tax system. Many of its imperfections are the result of an attempt to fit an improved capital cost recovery system into the faulty structure of present law.

Such imperfections as exist must be put in perspective. Compared to present law, NCRS is a meritorious system. If the only choice were between NCRS and present law, NCRS ought to be enacted. It is primarily when NCRS is compared to the ideal of first-year expensing that we tend to focus on imperfections.

1. *Cash Flow.* From the perspective of a business making capital investments, NCRS produces a less good up-front cash flow result than first-year expensing. Businesses that invest in capital equipment will in the first year and for several years thereafter be allowed to deduct smaller portions of the cost -- smaller even compared to present law. In effect, they will trade up-front deductions for larger deductions in the future. In effect, they are prepaying additional tax -- or lending the Treasury money -- which additional tax will be repaid with interest through enlarged deductions in the future.

2. *Indexing and Deductions in Excess of Cost.* Because NCRS does not allow the full cost of a capital investment to be deducted in the year paid, the deferred deductions must be indexed (increased) to reflect inflation. If the full cost were immediately expensed, no indexing would be necessary. Also because deductions for cost are postponed until the future, the amount of those postponed deductions must be increased beyond the initial cost of the property in order that their value to the business -- taking into account the time value of money -- will be equal to the value of deducting the cost of the property in the earlier year when the investment was made.

3. *Putting Complexity in Perspective.* Postponing deductions and then indexing and allowing enlarged postponed deductions adds significant complexity. The complexity of NCRS must, however, be put in perspective.

Should complexity be given greater weight when NCRS attempts to *reduce* the tax burden on capital investment than has been the case in the past when the law was amended to *increase* the burden on capital investment? For example, enormous complexity was created in 1986 when deprecation allowances were *reduced* through a combination of the present Modified Accelerated Cost Recovery System (MACRS) and the so-called Alternative Minimum Tax.

The complexity of NCRS must also be weighed against the importance of the principles involved and against the long-term benefits to economic growth and higher living standards that are logically associated with relieving the present tax bias against savings and investment the United States.

B. *NCRS in Overall Context*

NCRS is being proposed in the context of high federal deficits and a serious attempt to reduce and ultimately eliminate deficits in significant part through expenditure reductions; while at the same time enacting important tax relief.

As part of that tax relief, NCRS has a unique characteristic -- it actually *increases* tax revenues over the next four to five years by roughly $20 billion according to some estimates.

Here, again, we see the important premise of one tax instead of two as well as the important difference between the two possible approaches: (i) either allow an up-front deduction for savings and investment and later tax the return, including the return of principal, or (ii) do not allow an up-front deduction for savings and investment but do not later tax the return.

By, in effect, opting primarily for the latter approach through the mechanism of postponed deductions, NCRS is a valuable approach in the context of the near-term budget accounting equation. In that context, it is a way of currently enacting and putting in place an improved capital cost recovery system without any current-year revenue cost.

Such a result does not, however, arise by magic or alchemy. It arises from changing the timing of deductions -- less depreciation deductions now and more later. This timing change has consequences.

From a federal budget accounting standpoint, NCRS will result in very large future deductions and very large revenue costs after the first four to five years. These future revenue losses -- measured off the base of present law -- may impede efforts to achieve a balanced budget by the year 2002.

In contrast, actual expensing or some current step toward actual expensing -- such as increasing currently allowable depreciation deductions -- would have a current revenue cost, say for the next four years, but thereafter would not create the large over-hang of future deductions and revenue losses in years five through ten that arise under NCRS.

C. *Looking to the Future*

The future-oriented structure of NCRS and its future-oriented consequences raise additional considerations.

1. *A Good System in the Future.* On the positive side, after a few years of continuing capital investment with more and more property under NCRS, and as postponed deductions start to be realized in large amounts, NCRS will produce significant positive cashflow results for businesses.

2. *Changes in Tax Law.* Many businesses are, however, aware that the tax laws often change. Frequent change has particularly been the case in the past with depreciation and capital cost recovery. How reliable are the postponed deductions that NCRS inherently generates and upon which its efficacy and rationale depend?

Those who raise this issue are not necessarily saying that future Congresses will renege. Instead, they may be anticipating positive and desirable tax law changes in the future -- such as lower tax rates.

How could a lower business tax rate in the future be a case for concern from a business' perspective? The answer, I suggest, is mixed. One should be careful not to get carried away with criticisms of NCRS which may be based on the following proposition: A business will have given up present law deductions against a 35% corporate tax rate in exchange for future and enlarged deductions against a future tax rate that may be less than 35%. I understand the mathematics that the future deductions will, if the future tax rate is less, be worth less, but that does not necessarily mean that a business will be less well off than would be the case had NCRS not been enacted and present law continued.

3. *Fundamental Tax Restructuring*. I hope that a likely future event will be a fundamental restructuring of the American tax system. In one way or another, most such proposals contemplate first-year expensing of capital investment and contemplate lower tax rates as well. Some might be concerned that the existence of NCRS would make the transition to actual expensing more difficult. This is an issue to be fully explored and thought through.

My own answer, as an advocate of fundamental tax restructuring, is not so pessimistic.

There are two kinds of transition issues. One is the philosophical or tax policy transition of going from present law to full and direct expensing as is inherent in most restructuring proposals. That philosophical transition is made easier by NCRS. NCRS will in principle have crossed the Rubicon, so to speak.

The mechanical transition is more uncertain. It's ease or difficulty, including revenue considerations, partly depends on how quickly the transition occurred. If restructuring proceeds quickly after enactment of NCRS, the mechanical transition would be fairly easy. If it occurred three to five years later after a large amount of deductions had been postponed and were starting to become available, these deductions in conjunction with first-year deductions under a newly enacted expensing system could present a revenue problem.

D. *Alternatives to NCRS.* If alternatives are desired and are to be considered, and if fundamental restructuring is likely, I would suggest consideration of the following:

- Increase depreciation allowances under MACRS (the present depreciation system) to make them coincide as closely as possible to the depreciation allowances under the pre-1986 ACRS system as can be afforded in light of revenue constraints and the need for deficit reduction.

- Repeal or modify the so-called Alternative Minimum Tax so that it no longer penalizes companies for making needed capital investments.

Like NCRS, these changes would be good tax policy and be good for America. They also would be a down-payment on full expensing from a budgeting standpoint and, in that respect, ease the transition to fundamental restructuring.

The most important matter is to preserve the vital principle of NCRS -- that expensing or its equivalent is the correct analytical and policy result. We should not to lose the momentum toward enacting into law that and other principles of good tax policy that are in reality important strategic steps for America in the competitive world marketplace of today.

* * *

Chairman ARCHER. Thank you, Mr. Christian. I think you finished even before the yellow light went off. We are grateful for that.

Our next witness is Stephen Entin, resident scholar, Institute for Research on the Economics of Taxation. Mr. Entin, we would be pleased to hear your testimony. You may proceed.

STATEMENT OF STEPHEN J. ENTIN, RESIDENT SCHOLAR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. ENTIN. Thank you, Mr. Archer. My name is Steve Entin from the Institute for Research on the Economics of Taxation.

It is a pleasure to be here to talk to you about neutral cost recovery today. I was working at Treasury when the concept was first thought up, and it is nice to see that it has gotten somewhere in the last 12 years.

Just yesterday in the Wall Street Journal there was an article entitled, "Census Bureau Confirms Eroding Wages." This has been the subject of some concern for many years. It factored in the last two presidential elections, and I think it is time to do something about it.

One of the things we could do about it is give workers more and better equipment to work with and get businesses busy hiring and training them again to muster a work force to use the new capital. Unfortunately, the Tax Code is an obstacle. Investment writeoffs must be stretched out over many years, and consequently, the present value of the writeoffs is less than the investments cost. This is very peculiar. Revenues are not profit until they exceed the cost of producing the product or service. Businesses get to deduct all their wage costs, they get to deduct all their fuel costs, all their raw materials costs, and all their shipping costs. Why are they restricted to writing off only 75 to 95 percent of the real cost of their equipment and less than half the real cost of their factory buildings, offices, shops, and rental housing units?

By making businesses stretch out their writeoffs of plant and equipment, the current tax treatment of capital starts counting revenues as profits before the businesses really earned a cent. Taxes are sometimes due when no real profit has been earned. Investments in general have to earn more than otherwise to counter this tax bias, and trillions of dollars of otherwise attractive and valuable capital formation is lost.

The biggest losers are the workers whose productivity, wages, and job opportunities are curtailed. Government loses, too, as tax revenue is forgone on the lost GDP. Expensing is the straightforward cure, but it has an adverse impact during the budget window and it runs afoul of the PAY–GO provisions.

NCRS gets around that problem. It would provide all of the investment incentives of expensing for equipment immediately while raising revenue during the budget period. Equipment purchased in 1995 would benefit fully and the economic benefits of increased capital formation would begin right away.

NCRS would produce a significant reduction in the cost of capital, which would necessarily lead to a significant increase in the capital stock, higher productivity, and higher wages. GDP would ultimately be several percentage points higher. Annual growth rates might be increased anywhere from 0.5 to 1.5 percent a year for several years.

It would take only a small fraction of that projected growth, about one-tenth of 1 percent to two-tenths of 1 percent a year, accumulating to a bit over 1 percent higher GDP after about 10 years, to offset the static revenue cost of NCRS as projected by the Treasury. No reasonable forecast would show any growth less than that.

Furthermore, the additional growth of wages and employment would reduce the need for Federal income support payments. Both on the revenue side and on the outlay side, the deficit would be improved.

Regrettably, the committee has curtailed the NCRS adjustment for long-life equipment and structures to deal with Treasury's static revenue loss projection beyond the budget period. I think you should consider the additional economic growth and corresponding revenue reflow that NCRS would generate and restore the full NCRS treatment for all assets.

I also recommended on page 4 of my testimony that the committee consider, not only applying NCRS treatment to the AMT, but also adjusting the AMT asset lives to equal those of the ordinary tax system. I believe that the revenue reflow would justify both steps. I think they are entirely consistent and both are very valuable.

Criticisms of the NCRS proposal in recent Treasury testimony are unfounded. There are no tax shelters here. Treasury is twisting the term to mean any departure from the current biased system in which savings and investment are doubly or triply taxed. Viewed from the perspective of a neutral tax system in which savings and investment are treated evenhandedly relative to consumption, NCRS is the correct approach and anything less is a bias against investment.

To recap: NCRS can correct the underdepreciation of capital within the framework of the current budget rules and can get the economy moving forward now. The resulting growth will make it that much easier to trim government deficits as more jobs at better wages reduce the need for Federal income support payments. NCRS is a win-win proposal that is deserving of prompt passage. Why wait?

Thank you.

[The prepared statement follows:]

HEARING ON NEUTRAL COST RECOVERY AND EXPENSING OF INVESTMENT

Statement of Stephen J. Entin, Resident Scholar
Institute for Research on the Economics of Taxation (IRET)

before the
Committee on Ways and Means
January 26, 1995

Mr. Chairman and members of the Committee, thank you for the opportunity to present my views on the neutral cost recovery system (NCRS) proposed in H.R. 9.

The provision at issue — the only business-specific growth incentive in the "Contract With America" — relates to the write-off of depreciable assets. Under current law, businesses are allowed an immediate write-off (expensing) of only a small amount ($17,500) of the cost of plant, equipment, structures, and certain other assets. They must stretch out the remainder of the write-offs over many years, and, because the total amount of the write-offs is limited to the original outlay for the property, the present value of the write-off is less than the property's cost. The present value is reduced by the opportunity cost of money and by inflation, and this reduction is greater the longer is the life of the property and the higher is the rate of inflation. As a result, a real cost of production is understated, and the businesses' taxable incomes exceed their real incomes. Investment, productivity, wages, and employment suffer.

Under current law, purchases of equipment are written-off over periods of time ranging from 3 to 20 years. Most residential structures are written-off over a 27.5 year period. Commercial and industrial structures are written-off over a 39 year period. Stretching out the write-off period reduces the present value of the deductions due to lost interest and inflation. The result is that the business deducts an amount that is less in present value than the amount paid for the property. The under-depreciation overstates taxable income, resulting in a higher-than-statutory tax rate on the real earnings of the asset. The table illustrates the difference in the value of the deductions between expensing and one of the set of depreciation schedules commonly used in current law. For example, the real present value of deductions for the 7 year asset at 3% inflation is only 84.6% of the cost of the asset. The present value falls short of the amount paid for the property by $15.40 on a $100 piece of equipment, costing the firm an extra $5.39 in tax in present value terms, assuming a 35% corporate tax rate. The longer the asset life and the higher the rate of inflation, the greater is the loss in present value. At current rates of inflation, the present value of write-offs for structures is less than half of the cost of the property (not shown in the table).

Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-year Write-off).

Asset lives:		3 yrs	5 yrs	7 yrs	10 yrs	15 yrs	20 yrs
Present value of first-year write-off of $1 of investment		$1.00	$1.00	$1.00	$1.00	$1.00	$1.00
Present value of current law write-off of $1 if inflation rate is:	0%	$0.964	$0.937	$0.912	$0.877	$0.796	$0.742
	3%	$0.935	$0.888	$0.846	$0.789	$0.667	$0.592
	5%	$0.917	$0.859	$0.807	$0.739	$0.599	$0.519

Assumes a 3.5 percent real discount rate, assets purchased in first quarter of the year.

The most straightforward way of correcting under-depreciation is to permit expensing of the investment — deduction of the amount paid for the property in the year in which the property is purchased. H.R. 9 takes a useful but small step in that direction by increasing the allowable amount of expensing from $17,500 to $25,000. Going directly to expensing for all write-offs, however, would involve a large cost to the Treasury in the short run, and would run afoul of the PAYGO provisions of the budget law.

A cheaper near-term alternative is to spread the depreciation deductions over time but to allow deductions in amounts such that their present value equals the amount paid for the property. Such schedules constitute a "neutral cost recovery system" (NCRS). Under neutral cost recovery, businesses (corporate and non-corporate) would be allowed to adjust their depreciation write-offs annually by a normal real discount rate of, say, 3.5% plus the rate of inflation. This adjustment would approximate the normal real return on investment, and create write-offs equal in present value to expensing. It would allow businesses to recover their full real costs, the economically correct approach. NCRS would give a substantial boost to investment and wages.

One of the best features of NCRS is that it provides all of the investment incentives of expensing immediately while being consistent with the PAYGO provisions in the budget law. Equipment purchased in 1995 would benefit fully, and the economic benefits of increased capital formation would begin right away.[1] Nonetheless, because the provision requires businesses electing to use NCRS for short lived assets to employ the 150% declining balance method of depreciation (before NCRS adjustment) instead of the 200% declining balance method allowed under current law, the provision would raise revenue during the budget period.

H.R. 9 provides that the election of NCRS would be optional. Firms that would prefer to retain the slightly higher near term deductions and lower total write-offs of current law would be allowed to do so. NCRS will not harm any business, and will benefit most.

Investment tax credits (ITC) could also be used to offset all or part of the shortfall in value of normal depreciation allowances, though they are generally only an approximation of the shortfall. One drawback of the ITC is that the credit rates would have to be adjusted by statute as the inflation rate changed in order for the capital recovery system to remain neutral. Another drawback, in the current budget climate, is the large up-front cost to the Treasury. NCRS avoids both of these problems.

Growth and Budget Effects

A recent paper by Gary and Aldona Robbins[2] calculates that NCRS, as originally proposed, would have produced a 16% reduction, on average, in the pretax internal rate of return needed for an investment to be worthwhile. The modified version, trimming the adjustment for long lived assets, would be less effective in this respect. Additional capital would be accumulated until the rate of return fell to this new, lower value. It takes a great deal of additional capital to depress returns. Consequently, I would expect NCRS to produce an increase in the capital stock, over time, of perhaps 20 percent or more above levels that would otherwise occur. The higher capital stock and the resulting higher employment and productivity would boost the ultimate level of GDP by several percentage points over 5 to 10 years. Annual growth rates might easily be anywhere from 0.5 to 1.5 percentage points higher than otherwise during that period.

It would only take a fraction of that growth to make NCRS revenue neutral. Additional annual growth of only about 0.1% to 0.2%, cumulating to a bit over a 1 percent increase in the permanent level of GDP after 10 years, would offset the static revenue cost of NCRS. No reasonable estimate of the economic effect of a major reduction in the tax on capital could fail to predict several times that result.

NCRS should be adopted because it is the right thing to do. It reduces the anti-saving, anti-investment bias in the tax code, and raises incomes and employment. Nonetheless, the Congress does have legitimate concerns about the budget. Fortunately, NCRS is one of a small group of tax reforms that will almost certainly help rather than hinder deficit reduction. Not only would revenue increase, but the additional growth of wages and employment would reduce the need for federal income support payments.

Consistent with Neutral Tax Systems

A neutral tax system would not discriminate against saving and investment. The income tax, by taxing both income that is saved and the returns on that income, taxes income used for saving and investment more heavily than it taxes income used for consumption.[3] Dissatisfaction with this bias, and a determination to create a more neutral tax system, lie at the heart of all the major tax restructuring proposals that have been studied in think tanks, academia, and the Treasury, or submitted as legislation (such as Domenici-Nunn, the Armey flat tax, Danforth-Boren, and various VAT and national sales tax proposals). Some resemble income taxes, in which saving and investment are deducted from taxable income. Others impose a tax on goods and services that constitute final consumption, either at the retail level or during the production process.

Within the general framework of a neutral, consumption-based or saving-exempt income tax, there are two general approaches to creating neutrality. One is to exempt interest, dividends, capital gains, and other returns on capital from tax. This is akin to the tax treatment accorded state and local tax exempt bonds. The other method of achieving neutrality is akin to the tax deductible IRA. It involves allowing a deduction for income that is saved or invested, while taxing all the returns.

In such a system, all saving by individuals should get either "municipal bond" treatment or deductible IRA treatment (without the limits on contributions and holding periods attached to current IRAs, 401(k) plans, 403 (b) plans, SEPs, and Keough plans).[4]

In the case of direct investment in plant, equipment, structures, inventory, and R&D, the neutral treatment is "expensing", writing off the investment in the year it is purchased instead of depreciating it over many years. NCRS, which is equivalent to expensing in present value, is consistent with this neutral concept of taxation, and may be viewed as a step in the direction of a restructured, neutral tax system.

An additional source of bias in the tax code is the taxation of income at the corporate level and again at the shareholder level. This additional "double tax" applies to corporate income that is taxed and then distributed as dividends to shareholders, and to after tax corporate earnings retained for reinvestment, which increase the value of the company and are taxed again as capital gains when the shares are sold. Ideally, the corporate and individual income taxes should be combined or "integrated" (which means passing through corporate earnings and deduction to the shareholders as is done with subchapter S corporations and partnerships). Short of that, tax relief for dividends paid and for capital gains is in order. A final layer of tax on capital is imposed by federal and state transfer taxes, which should be eliminated.

Difficulties with the Committee Proposal

It is regrettable that the Committee has curtailed the NCRS adjustment for equipment with tax lives of 15 and 20 years and for residential, commercial, and industrial structures with tax lives of 27.5 or 39 years. The Committee proposal grants them only the inflation adjustment and not the 3.5% normal real return accorded other depreciable assets. Also, inventory outlays and R&D, which are equally deserving of NCRS treatment, are not covered.

The important principal behind NCRS is that businesses should be allowed a full write-off for all their costs of production, and that anything less overstates real business earnings. Once it is decided that it is all right to ignore a portion of the costs of production in calculating income for tax purposes, where does it end? Should businesses be allowed to deduct only 92% of their wage costs, or only 50% of their research expenses? The only deduction that is not entirely arbitrary is 100%, and that is also the only way to correctly value income and to maintain neutral treatment of income used for consumption and income used for saving and investment.

The Committee should consider the additional economic growth and corresponding revenue reflow that NCRS will generate and should restore full NCRS treatment of long lived equipment and structures, and should cover inventory investment and spending on R&D. If the Committee is too uncertain of the economic effects to proceed with a full adjustment immediately, it should at least affirm the principal of full adjustment by legislating a phase-in of the real 3.5% return in the current bill. For example, structures built in 1995 could receive inflation plus a 0.1% real adjustment; those built in 1996, inflation plus 0.2%; and so on until the full 3.5% real adjustment is achieved for structures placed in service 35 years from now. The phase-in would be slow enough to present little static revenue loss near term, and to avoid any tendency for investors to defer construction from one year to the next to achieve better tax treatment. The drawback to the phase-in, of course, is that the economy will not immediately experience the added growth that full NCRS treatment would provide.

H.R. 9 provides the same NCRS adjustment of the depreciation allowances under the alternative minimum tax as it does to the depreciation allowances under the ordinary income tax. This is proper and necessary to prevent additional businesses from becoming subject to the AMT, and to allow businesses that are subject to the AMT to recover their full costs of investment. It would be even better, however, to go an extra step and utilize the same asset lives in the AMT as under the ordinary income tax, in effect using the same capital recovery rules in the two systems. Under both systems, depreciation write-offs are to be made equal in present value to the cost of the property. It makes no sense to have two different sets of NCRS-adjusted depreciation tax schedules to achieve the same result, and to have two different tax systems that treat businesses differently according to whether their investment levels are high or low.

Unfounded Criticisms of the Proposal

Leslie B. Samuels, Assistant Secretary for Tax Policy, Department of the Treasury, raised a number of objections regarding NCRS in his testimony before this Committee on January 10, 1995. Most of his complaints are unfounded. I agree with only one assertion. He states that the provision of full NCRS treatment — inflation plus 3.5% — to assets with tax lives of 10 years or less, with longer lived assets receiving only the inflation adjustment, is discriminatory. This is correct. The solution, however, is to provide long-lived equipment and structures with full NCRS adjustment, not to deny the improved tax treatment to all assets by scrapping the entire NCRS proposal. Even as the proposal stands, long lived assets and structures would be treated better under NCRS than under current law. Given that they are currently treated much more harshly, relative to expensing, than short lived assets, the improvement granted to long lived assets, though incomplete, is nonetheless as significant as that given to short lived assets.

Samuels also expresses concern that businesses will engage in too much investment simply to offset other income with NCRS deductions. This is a distorted view. Rapidly growing, rapidly investing businesses might be unable fully to utilize their capital consumption allowances under NCRS unless they have sufficient other income against which to take their full write-offs. Such businesses would experience a penalty, the loss of a portion of the value of write-offs that had to be deferred. The presence of other income corrects what would otherwise be an unwarranted disincentive.

Samuels acknowledges that NCRS provides the same present value of deductions that would be allowed under (neutral) consumption based tax systems, but he mis-describes this as "reducing the effective tax rate on the income for new investment to zero (as under a consumption-based tax)." Samuels confuses "returns" with "income". In theory, in a competitive market, the present value of the returns on capital are driven down to levels that just cover the cost of the capital, and the tax saved by expensing the capital would just equal the tax on the returns, in present value. Thus, the returns are taxed, but do not yield a net tax to the government unless the returns exceed the cost of the asset. This is as it should be, for unless the returns exceed the cost, there is no net real income. If the returns exceed the cost, there is net income, and it yields a net tax. Income, properly defined, is taxed at the statutory rate.

A recent Wall Street Journal article[5] compared the results of neutral cost recovery with the accelerated cost recovery system plus ITC provisions of the Economic Recovery Tax Act of 1981, which eliminated the tax liability of some large businesses and supposedly produced negative tax rates. The ITC and the rapid write-offs in the 1981 Act may have resulted in a present value of write-offs in excess of full cost at low rates of inflation for some kinds of property. By contrast, neutral cost recovery, which automatically adjusts for changing inflation, cannot produce excessive write-offs or negative tax rates. And if, in some cases and time periods, an accurate accounting of the real investment outlays of a business would produce no taxable income, then that is the result the tax code ought to allow.

Other critics of NCRS have claimed, incorrectly, that there is a subsidy or "negative tax rate" applied to debt financed assets in current law, and that NCRS would worsen it. For example, a recent CRS paper[6] laments that, in the case of debt-financed investment under current law, businesses receive a write-off of an investment (which NCRS would enhance) plus a deduction for the interest paid on the funds borrowed to buy the asset. The tax lost to the interest deduction is called a subsidy to the business. This analysis ignores the fact that the interest paid by the borrower becomes taxable income to its lender. The tax paid on the interest by the lender is a rough "wash" for the tax saved on the interest by the borrower.[7] In the case of debt-financed investment, the lender and the borrower are de-facto "partners" in the investment, and receive the same combined tax treatment as investment financed within a partnership. This evenhanded tax treatment of investment regardless of the form of the business arrangement involved is a basic tax principal.[8] It is easy to make an activity appear to be subsidized if half the tax paid on the activity is omitted from the analysis. The truth is, if the business were not allowed a deduction for the interest, that amount would be taxed twice, once on the borrower's tax form, and again on the lender's. The combined tax treatment of the investment is correct under neutral cost recovery (hence its name).

Conclusion

Revenues aren't profits until they exceed the costs of producing the product or service. By making businesses stretch out their write-offs of plant, equipment, and structures, the current tax treatment of capital starts counting revenues as profits before the business has really earned a cent. Taxes are sometimes due when no real profit has been earned. Investments in general have to earn more than otherwise to counter this tax bias, and trillions of dollars of otherwise attractive and valuable capital formation is lost. The biggest losers are the workers whose productivity, wages, and job opportunities would be increased if the lost capital had been created. Government loses too, as tax revenue is foregone on the lost GDP. NCRS can correct the under-depreciation of capital within the framework of the current budget rules, and can get the economy moving forward now. The resulting growth will make it that much easier to trim government deficits, as more jobs at better wages reduce the need for federal income support payments. NCRS is a win-win proposal that is deserving of prompt passage.

Endnotes

1. Other approaches for moving to expensing that have only small near term outlays would delay the economic gains for years or decades. For example, it would be possible to phase in expensing over time, but the budget and economic consequences would be less favorable in the near term. One could allow businesses to expense 5% of their investment in 1995, 10% in 1996, and so on until 100% expensing is reached in 2014. This would cost some money during the budget window. Worse, the incentive to increase investment and capital formation would build slowly, with the result that there would be little economic improvement from the provision in the next several years. Indeed, the phase-in would create incentives to defer investment unless the phase-in rate were very slow.

2. "Neutral Cost Recovery: Investing for Growth, Not Planning for Taxes", Institute for Policy Innovation, Lewisville, TX, August, 1994.

3. Suppose that, in the absence of taxes, one could buy $100 of consumption goods or a $100 bond paying 4% interest, or $4 a year. Now impose a 20% income tax. One would have to earn $125, and give up $25 in tax, to have $100 of after-tax income to consume. The cost of $100 of consumption in terms of pre-tax income has risen 25%. To get a $4 interest stream, after taxes, one would have to earn $5 in interest, pre-tax. To earn $5 in interest, one would have to buy a $125 bond. To buy a $125 bond, one would have to earn $156.25 and pay $31.25 in tax. The cost of the after-tax interest stream has gone up 56.25%, more than twice the increase in the cost of consumption.

Put another way, in the absence of the income tax, each dollar of interest would, in effect, cost the saver $25 in current consumption ($100/$4). After the income tax, it would take $156.25 to buy $4 in interest or $125 of consumption. Each dollar of interest would cost $31.25 in foregone consumption ($125/$4), 25% more than in the no-tax situation.

There are two ways to restore neutrality. One is to exempt interest from tax. One would then have to earn $125 to buy a $100 bond, earning $4 with no further tax. This is akin to the tax treatment accorded state and local tax exempt bonds. The other method is to allow a deduction for income that is saved, while taxing the returns. One would have to earn $125 to buy a $125 bond, earning $5 in interest pre-tax, and, after paying $1 in tax on the interest, have $4 left. This is akin to the deductible IRA.

For a fuller discussion of the basic income tax bias against saving and investment, see:

Bradford, David F., et al, Blueprints for Basic Tax Reform, Second Edition, revised, Arlington, VA, Tax Analysts, 1984.

Schuyler, Michael A., Consumption Taxes: Promises & Problems, Washington, DC, Institute for Research on the Economics of Taxation, 1984.

Tax Reform for Fairness, Simplicity, and Growth, Vol. 3, Value-Added Tax, Department of the Treasury, Washington, DC, 1984.

Ture, Norman B. and Stephen J. Entin, Save, America, Washington, DC, Institute for Research on the Economics of Taxation, 1989.

Ture, Norman B. and B. Kenneth Sanden, The Effects of Tax Policy on Capital Formation, New York, Financial Executives Research Foundation, 1977.

4. At the very least, all these plans should be liberalized. The best measure would be the Breaux-McCrery universal IRA legislation (S.159 and H.R.328) that would create unlimited tax deferred individual investment accounts for all saving, with no restrictions on the amount of saving that could be deducted, no penalty tax on withdrawal at any age, and no forced distribution at any age. The Contract with America recommends a "back-ended IRA". While worthwhile in concept, a back-ended IRA could be crippled by the implicit taxation of otherwise tax free withdrawals created by the current method of taxation of social security benefits. See my testimony on reform of benefit taxation, Ways and Means Committee hearing, January 19, 1995.

5. Lucinda Harper, "GOP Pushing Big Corporate Tax Break In the Form of Depreciation Changes", Wall Street Journal, December 5, 1994, p.A2.

6. David L. Brumbaugh and Jane G. Gravelle, "The Neutral Cost Recovery System and the House Republican Contract", CRS Report for Congress, 95-75 E, Congressional Research Service of the Library of Congress, Washington, DC, Jan. 5, 1995.

7. There would be no tax paid by the lender if the lender were a tax exempt entity (charity, state government, church, etc., but that is due to the tax exempt status of such entities. Their income is tax free regardless of source, whether it be a contribution from a wage earner or interest on a savings account, federal bond, or corporate bond. The tax exempt status of charities has nothing to do with the correctness of NCRS or the treatment of debt finance at the business level under current law for taxable businesses and individuals.

8. The evenhandedness is violated, of course, by the "double-taxation" of corporate income at the business and shareholder level. Volumes of tax analysis have been written urging Congress to correct that error by providing dividend and capital gains relief, or complete integration of the corporate and individual income taxes. It is abundantly clear that it is corporate income that is incorrectly taxed, and that debt financed investment is receiving more correct treatment.

Chairman ARCHER. Thank you, Mr. Entin.

Our next witness is Thomas Usher, chairman of the American Iron & Steel Institute and president of USX Corp. Mr. Usher, we are pleased to have you with us. You may proceed.

STATEMENT OF THOMAS J. USHER, CHAIRMAN, AMERICAN IRON & STEEL INSTITUTE, AND PRESIDENT AND CHIEF OPERATING OFFICER, USX CORP.

Mr. USHER. Thank you, Mr. Chairman. My name is Tom Usher. I am president and chief operating officer of USX Corp. I am here today in my capacity as chairman of the American Iron & Steel Institute.

On behalf of the 34 U.S.-based member companies of AISI, I thank you for the opportunity to testify regarding certain provisions in the Contract With America. Our written statement lays out the steel industry's capital formation problems, including our technical suggestions on how to improve our tax laws.

Today, since I am not a tax lawyer, I am going to highlight our recommendations and discuss why changes are needed from the viewpoint of an American businessman. AISI fully supports the Contract With America's objective of lowering the cost of capital so that job-creating businesses can more easily invest in new plant and equipment.

Our cost of capital problems are caused because many of our steel companies remain mired in the alternative minimum tax on a seemingly permanent basis. The AMT reduces our cash flow and hinders our ability to pursue projects that will reduce costs, increase productivity, and preserve high-paying manufacturing jobs for Americans.

While our strong preference would be the outright repeal of the AMT or the consideration of fundamental tax restructuring, the Contract With America's objective of lowering the cost of capital for regular and AMT taxpayers is something that does get our attention. Conceptually the neutral cost recovery system is a step in the right direction.

NCRS should increase the present value of depreciation deductions for both regular and AMT taxpayers. However, even with NCRS benefits, taxpayers in an AMT position would continue to be discriminated against when compared to regular taxpayers.

A simplified version of NCRS, coupled with meaningful AMT reform, could go a long way to make the cost of capital for American steel producers competitive internationally. My one technical suggestion concerning NCRS is that it should be simplified.

We have only so much horsepower and we should be spending it to make steel, not projecting quarterly increases in the GNP implicit price deflator. Why not have Congress fix the depreciation tables in advance by projecting an average inflation rate?

Fixed depreciation percentage would reduce complexity and make long-range facility planning more certain. At the very least, indexing should be done annually instead of quarterly. In addition to NCRS, or if NCRS is not pursued, AMT reform should be a top priority and should be based on three principles.

First, accumulated AMT credits and other credits should be allowed to partially offset AMT liabilities. Second, investment recovery periods under the AMT should be the same as those under the regular tax. What economic sense does it make for our industry to have a 7-year recovery period for regular tax purposes and a 15-year period for AMT purposes? This change alone would give many AMT taxpayers nearly the same benefits as NCRS and would be much simpler.

Third, expenditures for nonproductive assets, such as pollution control equipment, should be expensed or at least not subject to the lengthy AMT depreciation schedules.

Why do American steel companies and other capital-intensive industries need these changes to lower the cost of capital? One need look no further than last week's news reports. The U.S. 1994 projected trade deficit for goods is expected to be the largest ever. Some may argue that the trade deficit is so high because U.S. manufacturers can't keep up with the growing U.S. demand for products. Why? Isn't it possible that our tax policies have discouraged U.S. capital investment, contributing to lost jobs and plant closings, and what about the factories that were never built because of our noncompetitive cost of capital?

Today the U.S. steel industry is recognized as having world class costs and world class quality. However, we are the only major economy in the world that is required to import a significant amount of steel due to the lack of domestic capacity. If we had added to our capital base, the trade deficit would be lower and America would have more good-paying manufacturing jobs. These were the jobs that made the American factory worker the envy of workers around the world. These were jobs with good health care, with wages that enabled a person to own a house, own a car, and educate their children. In short, quality jobs with a quality of life.

Americans need these jobs and Americans want these jobs. Sure we have created new jobs, but many of them are minimum wage jobs or low-paying jobs in the service area—fast food, restaurants, and shopping centers. More than two of these jobs are needed to provide a family with a standard of living than one manufacturing job provided years ago.

In conclusion, we congratulate the Members of the 104th Congress for recognizing that our current tax system penalizes new investment in plant and equipment. The concepts in NCRS combined with meaningful AMT reform are needed to improve our cost of capital and to preserve quality manufacturing jobs for Americans.

Thank you.

[The prepared statement follows:]

STATEMENT OF THOMAS J. USHER
PRESIDENT AND CHIEF OPERATING OFFICER OF
THE USX CORPORATION AND
CHAIRMAN OF THE AMERICAN IRON AND STEEL INSTITUTE (AISI)
ON BEHALF OF AISI'S U.S. MEMBER COMPANIES
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
JANUARY 26, 1995

This statement is on behalf of the 34 U.S. member companies of the American Iron and Steel Institute, who together account for more than two-thirds of annual raw steel production in the United States.

Mr. Chairman, AISI's U.S. members are grateful to you and this Committee for calling hearings on the tax provisions in the *Contract with America* designed to encourage greater savings and investment. In particular, we are pleased that staff has asked that this panel focus on the proposed Neutral Cost Recovery System (NCRS) in the *Contract* and the ways in which Congress can best address what continues to be a critical problem for U.S. manufacturers -- namely, **the grossly inadequate capital cost recovery system in the United States, especially as it affects Alternative Minimum Tax (AMT) payers.**

In general, AISI supports a fiscal policy that recognizes the need to reduce and hopefully eliminate the federal deficit over time, control surging health care costs, promote jobs and economic growth, and accelerate investments aimed at rebuilding U.S. infrastructure. As a top priority, Congress should enhance the competitiveness of U.S.manufacturing. It should ensure that the burden of taxation is as broad-based as possible so that it does not fall disproportionately on U.S. manufacturing, the nation's key source of good jobs. And it should study the potential advantages of a replacement tax system, because our existing business tax code is harming U.S. competitiveness.

Given these concerns, we would like in this statement to address not only the proposed NCRS, but the critical importance of further, significant AMT reform; the need to avoid new anti-competitive taxes; and the need to look seriously at fundamental tax restructuring through an entirely new approach.

NCRS: A Good Step in the Right Direction

With respect to NCRS, we applaud Congressman Nick Smith (R-MI) for developing this concept as a way of encouraging new investment by U.S. companies in productive plant and equipment. Its introduction as Title II in HR 9 (the Job Creation and Wage Enhancement Act) is a good step in the right direction, and we look forward to working with this Committee to ensure that the final bill achieves its goals in the vital area of capital cost recovery.

Our analysis of the proposed NCRS is driven by one overriding factor: the reality that many U.S. steel companies remain mired in the AMT on a seemingly permanent basis -- and the AMT has a 15-year (world's worst) capital cost recovery system. Thus, the chief reason AISI supports the NCRS proposal is that it markedly improves the net present value of depreciation under the AMT. **Additional, substantial AMT reform is one of the most important things the 104th Congress can do to keep the U.S. economic recovery going.**

With respect to NCRS specifically, we have the following observations:

- First, AISI absolutely supports the NCRS' four main goals of improving the capital cost recovery system, lowering the cost of capital, removing the distortions in the existing business tax system, and approaching the economic equivalent of expensing.

- Second, we strongly support the decision to extend NCRS benefits to AMT payers, because depreciation under the AMT's excessively slow recovery period is particularly subject to erosion by inflation.

- Third – because the AMT continues to be the single greatest distortion in the current system, the biggest disincentive to investment, and about as far as one can get from the ideal of expensing – the incentive to invest in productive plant and equipment that the NCRS provides will not be fully realized without additional AMT reform.

- Fourth, as NCRS is proposed, because 15-year AMT recovery periods will stay in place and continue to be more than double what they are under the Modified Accelerated Cost Recovery System (MACRS) of the regular corporate tax (seven years), depreciation for AMT payers will remain discriminatory and less beneficial than it is for regular taxpayers.

- Fifth, with respect to recent testimony by Assistant Treasury Secretary Leslie B. Samuels, we strongly agree that incentives should be focused on investments that improve productivity, but take issue with the idea that NCRS will enable permanent AMT payers to "zero out" their tax liability.

- Sixth, we would like to work with Congress to ensure the best possible provision and, in that regard, concerns have been raised about the proposed NCRS, including that: (i) it slows down depreciation for regular taxpayers in the early years; (ii) its benefits in later years could be reduced by a future Congress; (iii) NCRS does not fully meet its own objective to provide a present value of future deductions that is equivalent to the value of current expensing; and (iv) it represents a complicated new depreciation method that would add yet another layer of complexity to an already complex U.S. business tax system. At a minimum, to reduce complexity, NCRS indexing should be done annually, not quarterly. This could slightly reduce NCRS benefits, but would be a practical trade-off.

In view of these concerns, we think Congress should also continue to explore alternative, and possibly simpler and more direct, ways of achieving the worthy goals that this proposal embodies. One concept worth considering is simply to move to a system of straight expensing, possibly over a 5-10-year phase-in period. Yet another approach, which we strongly endorse, is to **focus in H.R. 9 much more directly on the anti-competitive nature of the AMT. If the goal is to effect tax code changes that promote investment in productive equipment and manufacturing competitiveness, Congress' highest priority should be additional, substantial AMT reform.**

AMT: The Need for Additional, Substantial Reform

The AMT originally was intended to ensure that all profitable U.S. corporations pay at least some fair share of tax each year. As you know, Mr. Chairman, that goal has been turned on its head. The changes to the AMT in the 1986 Tax Reform Act (TRA) have had the unintended effect of placing steel and other low-profit, capital-intensive companies in a near-permanent AMT status, with taxes being payable even in years where economic losses are incurred. As a result, the AMT is having a serious, adverse impact on U.S. capital cost recovery and a highly distortive effect on U.S. investment flows.

Unfortunately, the AMT reform contained in the 1993 budget bill – the elimination of the AMT's adjusted current earnings ("ACE") adjustment – does not solve the problem for steel and other investors in long-lived assets, including many of steel's key customers. Among other things, the 1993 reform still leaves intact the AMT's slower depreciation methods (150 percent declining balance) and long recovery periods (15 years) -- periods identical to those Congress abandoned in 1981 as being outdated and inadequate due to inflation and technological advances.

The AMT's discriminatory depreciation methods and excessively slow recovery periods have had especially harmful effects on the U.S. steel industry. That's because the AMT is most damaging to (i) companies that must invest heavily and continuously in productive equipment, (ii) companies in cyclical industries, and (iii) companies that are marginally profitable because they make products subject to intense domestic and international competition. That sounds like a classic definition that fits much of the U.S. steel industry. Thus, a good way to understand why the AMT is such a problem and why additional reform is so urgently needed is to look closely at the case of steel.

Since 1980, thanks in large part to massive self-help efforts and over $35 billion in investment in new steel plant and equipment, the United States steel industry has dramatically improved its competitive position. In spite of suffering major economic losses for a number of years, we aggressively restructured and modernized. As a result, today labor productivity in our industry exceeds that of even Germany and Japan, and we're the low-cost supplier of quality steel products to the U.S. market. That's the good news, because a strong and healthy steel industry is critical to the U.S. industrial and defense base.

The bad news is that we did all this in the face of an anti-competitive tax system and at enormous cost. We would have made even greater capital investments and competitive gains had it not been for the AMT, which forced steel companies to pay effective tax rates well in excess of the regular corporate rate and raised our cost of capital by as much as 20 percent.

The main problem continues to be the AMT's extreme bias against capital investment. This anti-competitive tax treats accelerated depreciation as an "adjustment" or "preference item " (an increase in income) that must be added back into the AMT calculation -- even when profits are low or non-existent and the economy is in recession. Insofar as U.S. steel companies have no choice but to invest heavily and continuously -- in good times and bad -- it is this "add-back" that increases taxable income, and thus forces many low-profit, capital-intensive steel companies into long term, if not permanent, AMT status.

Since passage of the TRA and its harmful AMT amendments, steel companies with significant reported losses (for both financial and regular tax purposes) have been forced to pay AMT and to defer any tax benefits associated with losses until regular taxes exceed the AMT, which may be never. Adding insult to injury, as steel companies have remained stuck in the AMT -- due to its perverse depreciation provisions -- they have been unable to use their accumulated minimum tax credits ("AMT credits"), which accrue in the years when the AMT exceeds regular tax liability.

The AMT credit, which can only be used when a taxpayer gets out of the AMT, was designed to ensure that, over time, no company would pay more tax than it would if it were in the regular tax. Most steel companies, however, have not been able to use the AMT credit against regular tax liability in subsequent years, as provided under current law. As a result, the AMT in effect has become the regular tax for most steel companies. That's because the buildup of deferred depreciation add-backs keeps us constantly in the AMT and thus unable to use our "pre-payments" to the government in a meaningful time frame. Meanwhile, the government has the advantage of our funds, interest-free, for many years.

As research done for the American Council for Capital Formation (ACCF) has shown, capital-intensive companies, like steel, that must continue to modernize immediately before or during an economic downturn, are penalized the most because of their buildup of deferred depreciation. What happens is that, when steel company incomes decline, the AMT forces us to pay higher effective tax rates that reduce cash flow at a time when cash flow is already weakened by low or non-existent profits. In addition, even if we were to choose to stop our capital improvement programs during periods of recession -- which is not a realistic possibility -- we would still pay more tax in a given year because the AMT's depreciation add-backs relate to prior years' capital spending.

Some steel companies, for example, have had years recently where they experienced large financial losses and losses for regular tax purposes, yet paid significant AMT amounts. Once again, the "problem" was the high level of capital investments -- and AMT depreciation preferences -- arising out of earlier years. Once again, loss-making companies were forced to pay a tax that acts more like a maximum tax. And once again, AMT credits could not be used.

With respect to the future, many steel companies are likely to remain stuck in the AMT for the remainder of this century and beyond. The reason may sound ridiculous but, as things stand now, we will have to stay in the AMT simply because we will need to continue high levels of investment to modernize our facilities and comply with Clean Air Act regulations.

It is critical, therefore, that Congress start to look at the U.S. business tax system as the steel industry now views the marketplace -- in a global context. According to a September 1991 analysis done by Arthur Anderson for ACCF, "when comparing the United States under the AMT with other countries, the United States ranks consistently at or near the bottom in terms of the present value of depreciation deductions and with respect to nominal capital cost recovery allowances, implying a disincentive to capital formation." This study concludes that , after five years, a U.S. steel company under the AMT recovers only 30 percent on its investment in plant and equipment, compared to 60 percent in Japan, 90 percent in Korea, and 100 percent in Brazil. We do not think the modest AMT reform of 1993 would change these conclusions.

Capital costs and capital formation remain critical concerns to our industry. In spite of the progress made in recent years, U.S. steel producers still face numerous competitive challenges, including (i) foreign companies that rely on government subsidies, dumping, closed markets and cartel behavior, (ii) large new costs to comply with U.S. environmental rules, and (iii) high pension and health care legacy costs. Under these circumstances, the last thing we need is an anti-competitive tax that penalizes investment, raises the cost of capital, and impairs capital formation.

The AMT is hitting the wrong people for the wrong reasons. It was enacted to ensure that no corporation with substantial economic income could deliberately structure its finances to avoid tax liability. Instead, it is placing capital-intensive, low-profit U.S. steel companies at a severe competitive disadvantage -- not only against non-AMT paying domestic producers of competing materials but against foreign competitors, who pay no income tax when they have no profits and whose depreciation is not subject to an AMT.

Congress knows the problems. The AMT is imposing a tremendous administrative burden, because it requires numerous depreciation and inventory calculations. It is inherently inequitable, because it is providing vastly different tax treatment to similar investments made by similar taxpayers. It is acting as a competitive drag on U.S. manufacturing. It is penalizing in particular those companies that invest the most in relation to their profits. It is impeding new investment by many companies, because the AMT's depreciation add-back is applied retroactively. And by denying the use of pre-paid regular tax -- i.e., AMT credits -- at all, or within a meaningful time frame, the value of these credits is rendered worthless. It is time for additional, substantial AMT reform.

AMT Reform: What Congress Should Do

Mr. Chairman, it is clearly our view that further, significant AMT reform should be your highest tax policy priority at this time. Therefore, should Congress choose not to adopt the proposed NCRS, we would ask that you carefully consider our recommendations on ways in which the AMT can be changed to achieve some of the same goals as NCRS.

With respect to AMT reform, we ask you to consider the following principles -- that: capital cost recovery provisions should promote, not impair, manufacturing investment and competitiveness; recovery under the AMT should be no longer than under the regular tax; AMT credits should be made available to companies that find themselves in the AMT; the regular corporate income tax should be the dominant tax regime for all taxpayers over an extended period of time; and under no circumstances should expenditures for non-productive pollution control and abatement equipment be subject to the AMT.

Given these principles, we urge that Congress do three things:

- **First, make the AMT's anti-competitive capital cost recovery period consistent with that of the regular corporate tax for investments in long-lived assets.** This would help mitigate the discrimination -- and the penalty -- that the AMT now imposes on investment. Such a change would be less complex to administer than the proposed NCRS and, viewed from a cash flow perspective, many AMT payers might prefer the certainty of a shorter recovery period to potential NCRS benefits. If Congress still wants to maintain an AMT penalty, it would be more than sufficient to limit it to a slower write-off method (150 percent declining balance for AMT versus 200 percent declining balance for regular tax).

- **Second, change the way the AMT credit operates to make it usable for industries such as steel.** The AMT was never intended to tax capital investment at a higher rate than the regular tax on a permanent basis. But this is exactly what happens when AMT payers are denied use of the credit. Since many AMT payers will not have enough regular taxable income to utilize their AMT credits fully in a meaningful time frame, a mechanism should be established to allow partial utilization of credits against AMT liability. In the past, AMT-paying companies have supported legislation to permit taxpayers with certain unused minimum tax credits to offset up to 90 percent of the total of current year regular and net minimum tax liabilities. This would monetize these credits and thus decrease the cost of capital. It would also stimulate economic growth by liberating funds for additional capital investment.

- **Third, exclude investments in environmental equipment from the AMT's depreciation add-back calculations.** Such investments inevitably reduce the money available for modernization projects to improve productivity and competitiveness. That is why there are good reasons to consider the immediate expensing of non-productive pollution control and abatement equipment. At the very least, such expenditures should be excluded from the AMT's restrictive depreciation calculations.

New Anti-Competitive Taxes: What Congress Should Avoid

Turning to another issue of long-standing concern to steel, AISI is especially pleased that the *Contract* takes a strong stand against new anti-competitive taxes. In the 1993 debate over the proposed BTU tax, we think one key message was that the United States must avoid imposing a layer of new costs on U.S. producers of domestic and exported goods -- cost increases that are not borne by imports and foreign competitors.

New energy taxes are of obvious concern to the steel industry, because steel remains America's largest industrial user of energy, accounting for about three percent of all of the energy consumed annually in the United States. Purchases of energy account for roughly 20 percent of the cost of manufacturing a ton of steel. And most of this energy -- including electricity -- is derived from carbon fuels such as coal, natural gas and oil, which remain essential inputs in the steelmaking process.

Steel has been doing its part to help create a cleaner environment that uses less energy; the Institute's U.S. members have achieved a reduction of over 40 percent in energy consumption per ton of steel shipped since 1975. Our main concern is that new energy taxes in the U.S. not impose a solution to national -- and global -- energy and environmental problems that would make U.S. manufacturers less competitive. For example, the direct and indirect effects of the proposed BTU tax -- even with the suggested exemptions -- would have added at least several hundred million dollars to steel's annual operating costs.

Western Europe has taken steps -- including industrial user exemptions -- to ensure that its manufacturers are not harmed by efforts to promote a cleaner environment and energy conservation. Still, U.S. proposals continue to surface that would cost jobs and impose unilateral burdens on manufacturers in the United States.

Examples of recent suggestions for new anti-competitive taxes include proposals for (i) a 125% increase in the inland waterways fuel tax, (ii) a new hard rock minerals tax, (iii) a 200% lead tax, and (iv) a higher tax on vessels and cargo which, as part of maritime reform legislation, actually passed the House in 1994. All of these would have had serious adverse impacts on the United States steel industry. With your help, none will become law this year.

<u>The System Is Broken: The Need to Study Fundamental Tax Restructuring</u>

Of course, not all taxes are anti-competitive, and that brings us to a final issue of concern -- the prospects for systemic reform. Mr. Chairman, you said recently that you have "just about given up hope" that the present income tax system can be reformed. As AMT payers, we strongly agree with you that the present tax system is broken and that the issue of crafting an entirely new approach as a replacement to the current system deserves further study.

Most of AISI's focus over the past several years has been on studying the pros and cons of a substitute "border-adjustable" tax (BAT) -- a tax applied equally to domestic production and imports, but not to exports.

Our chief interest has been on the international competitiveness aspects of a BAT. The United States is virtually the only major economy in the world that does not use some form of GATT-legal BAT on business activities in its territory. In Western Europe, Japan and other markets, U.S. exporters and the products they sell face a BAT upon entry. But in the U.S. market, foreign companies are not required to pay a BAT on the goods they sell here -- and they get a rebate of their own government's BAT when their products leave as exports.

Take the North American Free Trade Agreement (NAFTA) as another example. While NAFTA will eventually eliminate duties on intra-NAFTA exports of steel and other products, U.S. exports will continue to be charged a seven percent goods and services tax upon entry into Canada and a 15 percent value-added tax (VAT) upon entry into Mexico. At the same time, these taxes will continue to be rebated for Canadian and Mexican exports to the United States.

These examples show that there are good reasons to think that, if properly constructed, fundamental tax reform through a <u>substitute</u> BAT could lower the cost of capital, simplify the U.S. business tax code, improve U.S. competitiveness, promote U.S. exports, and provide additional revenue (from imports) for deficit reduction and other important national goals. In addition, BAT proponents say that this could all be done without raising taxes for U.S. businesses or causing significant price hikes for U.S. consumers. In other words, they believe that a BAT need not have the adverse impacts of a European Union-type VAT, which is applied at every stage of production as well as to the end-user.

At the same time, some important concerns have been raised about fundamental tax reform through a BAT, especially as regards transition rules. To be acceptable, therefore, fundamental tax reform must conform to certain key principles. Among other things, it should: (i) replace current and proposed taxes on U.S. companies, so that there is no net tax increase on U.S. businesses; (ii) provide for immediate expensing of new plant and equipment purchases; (iii) be simple and relatively easy to administer; (iv) be border-adjustable; and (v) insist on good transition rules that would allow U.S. businesses to maintain tax assets or credits (e.g., net operating loss carryforwards and AMT credits) that they have accumulated under the current system.

Mr. Chairman, as you proceed to study the pros and cons of an entirely new approach to our existing business tax system, AISI stands ready to help in any way we can.

Conclusions

To summarize:

- AISI supports the NCRS proposal in the *Contract with America* designed to encourage new investment by U.S. companies; it's a good step in the right direction, because it markedly improves depreciation under the AMT, the world's slowest capital cost recovery system.

- AISI places the highest tax policy priority on additional, substantial AMT reform; this is one the most important things Congress can do to keep the U.S. economic recovery going.

- Should Congress choose not to adopt NCRS, we suggest strongly that it reform the AMT by (i) conforming its recovery period to that of the regular tax, (ii) making AMT credits usable, and (iii) excluding environmental investments from the AMT.

- With respect to other issues of concern to the steel industry, we are grateful that the *Contract* opposes imposition of new anti-competitive taxes (e.g., energy taxes), and agree with the Chairman that the issue of fundamental tax restructuring deserves further study.

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We thank the Committee for this opportunity to present the views of AISI's U.S. member companies on tax policy issues of growing importance to the United States steel industry.

Chairman ARCHER. Thank you, Mr. Usher.

Our next witness is Andrew Sigler, CEO of Champion International.

Welcome.

STATEMENT OF ANDREW C. SIGLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHAMPION INTERNATIONAL CORP., STAMFORD, CONN., ON BEHALF OF THE AMERICAN FOREST & PAPER ASSOCIATION

Mr. SIGLER. Thank you, Mr. Chairman. And thank you for giving us this opportunity today.

I represent the American Paper & Forest Association and Champion. I will attempt to make my comments principally from the position of Champion. I have to say, that the first thing I would do is second the testimony of Tom.

One of the things that I think is important to remember when I listen to the comments of others here this morning, when you are talking about business, you tend to lump us together and we are all very different. We are a capital-intensive cyclical business, as is steel. We spend an enormous amount of money to gain the ability to sell one ton of paper. We produce a basic world commodity, and our profitability will always flow up and down with cyclical swings of the U.S. economy, and for both of our industries, the world economy.

Our tool is capital spending. We have to spend to make money. It is not a matter of stopping spending, because technology changes. We spend an immense amount of money to keep and maintain the equipment that we have.

We spend the money on new technology to make us more competitive. We spend an immense amount of money on new technology, to meet the requirements that we have on the environmental side. So it is not a matter of saying we will spend or we will not spend. That is the tool we use. And we think the way that tool is treated by the tax laws makes it very difficult for us compared to a lot of other businesses.

I will use 1986, because I want to make a comment about AMT, myself. Since 1986, we have spent more than $6 billion. In that time, we have created approximately 4,000 new jobs. These are high-paying, highly skilled, highly trained people. We have created jobs in regions with the construction and ongoing performance of the facilities that we built. It is a great economic plus for the small businesses that supply us at all stages.

I speak in support of the proposed neutral cost recovery legislation, on the basis that anything that can help us in the recovery of our capital is a positive thing.

I would like to speak a little bit more to the recovery side than the cost side. I don't believe that we make decisions on $1 and $2 billion mills based upon a fluctuation in the tax rate, et cetera.

We make investing when we have the available cash, and the speed of recovery of our capital is a lot more important, personal opinion, than the cost of our capital. But we tend to lump them together and we have talked more about cost than we have about recovery of investment. Certainly, this bill addresses both.

We have the same concern that has been expressed before, about the lack of confidence that these proposed cost recovery rules will stand up over an extended period of time. They certainly haven't in the past.

I want to make a specific comment, and I don't want to repeat what Tom has said, but the 1986 enactment of AMT has created a very difficult thing for our company. We have been on AMT for the last 6 years.

I don't know that we will ever get off it. That means that the recovery of our capital is pushed out to the furthest point, which is probably, in our case, 13 to 14 years. AMT forced us to pay taxes when we were losing money. We were only making money if you assumed that depreciation is income, as the AMT does. So we could not take advantage of even current law incentives for investment, nor could the vast majority of the paper industry, because of AMT.

So we like to talk about the theory of improved cost recovery, and I think the proposal is different and it makes a lot of sense, but it is academic to us, because AMT lays out there. And until some adjustments are made in AMT treatment of depreciation, we will not be able to take advantage of anything that you might do under the regular tax.

Thank you very much.

[The prepared statement and attachment follow:]

STATEMENT ON "CONTRACT WITH AMERICA"

ANDREW C. SIGLER
CHAIRMAN & CHIEF EXECUTIVE OFFICER
CHAMPION INTERNATIONAL CORPORATION

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

JANUARY 26, 1995

Mr. Chairman and Members of the Committee, I appreciate very much your invitation to be here today to discuss the opportunities facing this nation for continued economic growth and job creation through increased investment in productive plant and equipment. I commend you for including this issue as one of your first 100-day agenda items. I am speaking to you today, not only as a representative of my company, but on behalf of the American Forest and Paper Association[1]. You will not find a stronger supporter nor a better example of the role of investment in creating good, high-paying manufacturing jobs than the industry represented by this association.

I have been the CEO of a major forest products company for some 20 years now and have seen many changes in tax policy designed to motivate one type of behavior or another over the years. I can tell you from experience that the tax code does make a difference. It can either encourage or discourage new investment. Today, I believe the tax code discourages new investment, particularly because of the broad scope of the corporate Alternative Minimum Tax (AMT).

The pulp and paper segment of the industry is one of the most capital intensive[2] and internationally competitive industries in the world. We have invested more than $130 billion in new pulp and paper production and pollution prevention equipment since 1980. This amount accounts for about ten cents of every sales dollar from paper products, the highest reinvestment rate of any U.S. manufacturing industry.

This industry is also a great example of the positive effect of investment on productivity. As a result of our investment, productivity has improved dramatically, costs are down and this industry is a strong global competitor. That doesn't mean, however, that we can become complacent. Industry technology is rapidly changing, world-wide competitors are proliferating, and proposed government regulations require new environmental technologies to be adopted.

Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code discourages that investment in a number of ways. Compared to our international trading partners, the U.S. tax

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[1]The American Forest and Paper Association (AF&PA) is the national trade association representing producers of paper, pulp, paperboard and wood products, as well as the growers and harvesters of this nation's forest resources. The industry has over $200 billion annual sales, employs 1.6 million workers, has an annual payroll of $49 billion, and is among the top ten employers in 46 states. Forest products represent more than seven percent of U.S. manufacturing output.

[2] Each employee in the pulp and paper business is supported by $123,000 of plant and equipment.

code is significantly less favorable for investment.[3] The enactment in 1986 of AMT, plus the loss of the investment tax credit and capital gains rate differential, and the lengthening of recovery periods under regular tax depreciation have all raised the cost of capital and reduced the funds available for investment in job creating assets. This trend of recent tax changes must be reversed to provide more favorable and predictable treatment of investment.

The forest products industry strongly supports the goals of the "Contract with America" and its proposed Neutral Cost Recovery System (NCRS). We have long advocated more favorable cost recovery rules and commend the Committee for seeking tax changes to increase productivity and economic growth. We believe that in the long-run increased investment is the best way to improve the standard of living for all Americans.

Pulp and paper manufacturing assets are relatively long-lived, with recovery periods under the regular tax of seven years and 13 years under the AMT. Since it takes so long to recover the cost of investment for tax purposes, there is significant loss in the value of depreciation deductions due to inflation and the time value of money. We believe that NCRS, if enacted and left unchanged for years to come, would prove quite beneficial in two ways. (See attached table.)

First, NCRS would take a significant step toward removing the AMT penalty from future investment and could be an important step toward ensuring that investments in similar assets are treated in a like manner regardless of the profitability of the taxpayer. Second, it would allow us to more aggressively replace old and outdated equipment, meet capital demands for environmental spending, and would enable this industry to be internationally competitive well into the next century. The benefits of being competitive ultimately flow to American workers through development of new job skills that make them more valuable and lead to increased wages.

Our primary hope, however, is that you will make improvements to the cost recovery system that will be sustainable over a long period of time. The frequent changes in the tax law only create uncertainty in planning for new investment and ultimately make the tax code less effective in motivating positive behavior. We recall all too clearly and all too painfully, the roll back of investment incentives in 1986 and the retroactive impact of AMT which changed the economics of many investments in the 1980s after they had already been made.

If budgetary or political constraints require your Committee to fine-tune or possibly even consider alternatives to NCRS, I hope you will at a minimum try to make improvements to what I believe is the most detrimental aspect of the current tax law with respect to investment – the anti-capital bias of the Alternative Minimum Tax.

Much of the forest products industry is subject to AMT simply because of the amount of investment required to be competitive. In fact, my company has been paying AMT since 1987, when it was first effective. The combination of high investment and cyclical profits has meant that the $4.7 billion of investment in plant and equipment that Champion has undertaken since 1987 has been severely penalized by AMT.

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[3] Special Report, "The Impact of the Alternative Minimum Tax on Investment and Economic Growth," Table 2, American Council for Capital Formation, Washington DC, November 1990.

Under the AMT, our assets are subject to the worst capital cost recovery system among our major international trading partners. In fact, the AMT directly increases the cost of capital for pulp and paper manufacturing assets by some 10 percent over what it would be under the regular tax system.[4] This is due in large part to the extended recovery periods under AMT, which are about twice as long as that used for regular tax purposes.

The AMT is particularly pernicious because a company is hit hardest when it can least afford it. AMT increases taxes when profits decline and cash flow is constrained. Yet most capital intensive companies cannot simply stop investing because profits have temporarily fallen. The investment must be completed in order to generate income in the future. As a result, companies can pay the AMT penalty on investment even when they may actually be losing money.

When the economy improves and a company's profitability returns, its AMT problems are not necessarily over. Often, the company does not have enough regular taxable income in the short-term to fully offset the large amounts of AMT credits that have been generated in bad economic times. This is particularly the case for the forest products industry. At some point during the past five years, almost every forest products company was in an AMT position.

When the law was originally written, Congress did not intend for companies to incur a permanent tax increase as a result of AMT, so they created a credit for the difference between AMT and regular tax liability. This credit can only be used to offset future regular tax liability. The problem with this credit, however, is that many companies have accumulated so many credits that they will not be able to use them in a meaningful time frame. When they can finally use them, the credits will be of little value due to inflation and the lost alternative use of the money. Consequently, many companies are providing the U.S. government with an indefinite interest-free loan.

The proposed NCRS does in fact provide improved depreciation for both regular and AMT firms and, therefore, the forest products industry supports its enactment. The proposal does not, however, completely eliminate the AMT penalty on investment. There will still be a significant cash flow difference between AMT and regular tax depreciation because of the extended length of the recovery period under the AMT.

Should your Committee decide to make changes to NCRS or consider alternative proposals to encourage investment, we would recommend that priority be given to reform of the AMT. One possibility would be to conform AMT recovery periods to those under the regular tax.

Additionally, and perhaps more long-term, we hope the Committee will consider solutions to other AMT problems such as the inability of taxpayers to fully utilize AMT credits in a meaningful time frame.

I appreciate the opportunity to comment on the employment and investment aspects of the "Contract with America" and I applaud you for taking this first step toward putting our nation on a path toward sustained economic growth and new job creation.

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[4] Special Report, "The Impact of the Alternative Minimum Tax on Investment and Economic Growth," Table 1, American Council for Capital Formation, November 1994.

TABLE A

Effect of NCRS on Pulp and Paper Manufacturing Assets

7 year -- Regular Tax Depreciation
13 year -- AMT Depreciation
per $100 of investment

Year	Regular Tax Amount	AMT Amount
1	10.71	5.77
2	20.45	11.62
3	17.18	11.00
4	14.97	10.40
5	16.00	9.83
6	17.10	9.48
7	18.28	10.13
8	9.77	10.82
9		11.58
10		12.37
11		13.23
12		14.12
13		15.11
14		8.06
Total	124.46	153.52
Discount rate*	7.46%	7.46%
Present Value of costs recovered	94.51	93.53

*November 1994 Long-Term Govt. Bond Rate

Chairman ARCHER. Thank you, Mr. Sigler.

Our last witness of this panel is Donald Schapiro, partner with Chadbourne & Parke in New York.

Mr. Schapiro, we are delighted to have you with us.

Welcome.

STATEMENT OF DONALD SCHAPIRO, PARTNER, CHADBOURNE & PARKE, NEW YORK, N.Y.

Mr. SCHAPIRO. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to testify before this hearing.

I am a practicing lawyer in New York City and I am appearing here today in my individual capacity as a person who is familiar with the tax law. I work with it every day and I have done that for a long, long time.

My testimony is directed to what may be the unpopular technical subject of the technical aspects of this bill. It is not directed to the economic issue of lowering the cost of capital. I would like to talk with you about and share with you some views I have about the language of the bill, how it works and what it does as a matter of sound tax policy.

I would ask you to bear with me and to refer to my testimony. There are some tables there which I would like to talk about because you cannot really understand this unless you look at numbers, or at least I cannot. So I would like to ask to you look at numbers. It is not talking about budgets, it is just talking about numbers and depreciation, the way businesspeople would see it out there.

Let me start out by saying that the proposed system would give taxpayers extra depreciation deductions for tangible property placed in service after December 31, 1994. These extra deductions would not reduce the cost basis of property and would not be subject to recapture.

They are really very much like tax credits. And to understand what the bill does, technically, one must understand what a tax credit does. And—my prepared testimony tries as best it can to explain that.

Now, I am going to use the phrase "NCR bonus depreciation" to refer to these extra deductions which come and which don't reduce basis. Now, there are two kinds of these bonuses in the bill. One is automatic and applies only to property having a cost recovery period of 10 years or less. That is the 1.035 inflater.

The other kind applies to all property, including that benefited by the 1.035 inflater, and is indexed to inflation.

I would ask you to now bear with me. It is really only 2 minutes or so that I would ask you to do that, to turn to the tables in my testimony—so that at least I can demonstrate how this works.

Now, on exhibit 2, on page 5, the first column is years. The second, third, and fourth columns, (a), (b), and (c), show inflation rates which is just really a mathematical thing on a calculator. And it shows that $1 invested at 3.5 percent would grow, for example, in 39 years to $3.70. That is table (a). Or at 5 percent, to $6.39 or at 7 percent to $13.08.

Let me now ask you to look at line 10 of that table, year 10. That says that a dollar invested at 3.5 percent inflation rate would grow to $1.36 and $1.55 and $1.84. The NCR inflation bonus is 36 percent of the depreciation taken in the 10th year, at a 3.5 percent assumed rate of inflation; 55 percent, at a 5 percent assumed rate of inflation and 84 percent at a 7 percent assumed rate of inflation. That is the added bonus measured by the otherwise allowable depreciation.

Now, if you look at 15 years down the line in columns (d), (e), and (f). you see that at a 3.5 percent rate of inflation it is 62, 98 and 158 percent going across. If you combine the two, both the automatic and the other, that is combined in the table below. And for 10 years, you would get an additional bonus depreciation of 85 percent at one assumed rate of inflation, 110 percent at another and 150 percent at another. Which means that is the extra deduction.

Now, the tax value of these extra deductions is set out on the following page, and you can trace it through.

Let me just say, as a matter of technical tax policy, the committee should consider that under a system like this, with increasing amounts of depreciation deductions as property ages, the taxpayer would have an incentive to keep old property. Unlike the investment tax credit, this does not encourage new investment. It encourages keeping old, worn-out stuff because if you throw it out, you lose these bonuses. This is like a wine cellar, the older the wine, the better, because it keeps generating these extra bonuses.

The second thing to keep in mind is the fact that debt is not indexed, which is a point previously made, and that produces unfairness. The rest of the comments I have are in my prepared statement.

[The prepared statement and attachments follow:]

Testimony of Donald Schapiro, New York, NY
January 26, 1995

My name is Donald Schapiro. I am a partner of the law firm of Chadbourne & Parke in New York City, and a visiting lecturer in law at Yale Law School. I am appearing today in my individual capacity as a person familiar with the tax law.

Section 2001 of H.R. 9, (the "Bill") would amend the depreciation deduction provisions for property placed in service after December 31, 1994.

(1) It would substitute the 150% declining balance method for the 200% declining balance method for tangible property having a recovery period of ten years or less. Property otherwise depreciated at 150% declining balance or under straight-line depreciation would retain the existing method of depreciation.

(2) As an offset to the detriment to taxpayers from the switch from the 200% to 150% declining balance method, the amount allowable under the 150% method in each year for property so switched would be increased by an exponential factor of 1.035 which is shown in column (a) of Exhibit 2 attached. The effect of this change is illustrated in line 3 of Exhibit 1 attached.

(3) In addition to the increase in depreciation deduction based on the 1.035 factor described in (2) above, there would be an increase in annual depreciation deductions, as increased by the 1.035 factor where applicable, to reflect an indexing for inflation. This inflation indexing increase would apply irrespective of the recovery period of the property. Thus, it would apply to property covered by the 1.035 factor as well as property with a longer life, including real estate. The effect of this change would depend on the rate of future inflation and the period of depreciation. Exhibit 2 attached shows how the increased deduction would be calculated assuming annual inflation indexing of 3.5%, 5% and 7%, without taking into account the 1.035 factor. Exhibit 3 attached combines the 1.035 factor with various assumed rates of inflation indexing.

(4) I will refer to the combined extra depreciation allowed under the 1.035 formula and the inflation indexing as the "NCR Bonus" (i.e., bonus depreciation under the neutral cost recovery system). Where a separation between the elements is relevant, I will distinguish between the 1.035 factor NCR Bonus and the inflation indexing NCR Bonus. The NCR Bonus does not reduce the basis of the property; nor does it increase the amount subject to recapture at ordinary income tax rates. Thus, while the NCR Bonus is referred to as a "deduction," it has the characteristics of a tax credit, calculated by multiplying each year's NCR Bonus by the taxpayer's federal tax rate.

(5) The existing federal tax system does not contain an equivalent type of "deduction-credit" concept, and so far as I am aware there has never been such a concept in the federal tax system. There are a number of problems which should be considered in this connection, including the following:

(a) As property ages, taxpayers would have an incentive to allow it to remain in service, because the NCR Bonus will be available each year the property is kept in service, and will grow with inflation. For example, assume property with a remaining cost recovery period of five years is being depreciated on a straight line basis at the rate of $100 a year before the NCR Bonus. If the property were abandoned, there would be a deduction of $500. On the other hand if the property is continued in service, there will be five years of NCR Bonuses available in addition to the $500 deduction.

(b) There could be an administrative problem for the Revenue Service in determining when property has been removed from service and the NCR Bonus ceases.

(c) The NCR Bonus is available for debt financed property and for leased property. Where leased property is debt financed, the NCR Bonus can amount to an inflation hedge for lessors. Assume, for example, property having a recovery period of 20 years is mainly debt financed and net leased to a user for an annual rental equal to the debt service. In such a case, the higher the rate of inflation, the higher the NCR Bonus each year to the lessor, even though the lender is bearing the risk of inflation. Possibilities such as this suggest that tax sheltering may be increased as a result of the Bill.

(d) It will presumably be necessary for all taxpayers to accumulate additions to the cost of an asset in annual segments, because each year's additions to cost will presumably start their own NCR Bonus calculations. The required computations are likely to be complex and may be difficult to audit.

(e) The NCR Bonus system is likely to influence the manner in which assets are bought and sold. Thus, where an older NCR-qualified asset is held in corporate form, a transfer by a stock sale would be much more advantageous, because the NCR Bonus entitlement would not be lost. This sort of transferability could generate tax shelter activity. The Committee may wish to consider whether a provision like section 382, which is designed to discourage traffic in tax losses, might be appropriate.

(f) Taxpayers will place great stress on avoiding loss of NCR Bonus due to terminations of partnerships and other transfers of property. A similar problem arose on the recapture of investment credits, but the recapture was for only seven years at decreasing amounts, and did not apply to real estate.

(g) The anti-churning rules referred to in sub-section (k)(6) are not reprinted in the present Internal Revenue Code. These rules were not designed for NCR Bonuses. They are not wholly clear, and only proposed Treasury Regulations have been published under them. I strongly recommend that these rules be carefully reviewed, enacted as part of the current code, and illustrated with a detailed committee report. They are the first line of defense against transactions which are not intended to be covered, and should be examined with care and clearly explained. Further, rules should be provided as to which types of transfers will allow the transferee to step into the shoes of the transferor as to retaining entitlement to NCR Bonuses.

(6) The Ways and Means Committee may wish to consider whether the NCR Bonus should be modified where property is debt financed and whether special attention should be paid to the passive loss rules, traffic in corporations holding old NCR Bonus property, and other tax sheltering opportunities. Potential administrative difficulties of determining when property has been removed from service might also be reviewed.

(7) The Committee might wish to review Exhibits 1, 2, 3 and 4 attached to determine whether the benefits of the NCR Bonus should be changed. For example, Exhibit 4(a) shows that real estate with a 39 year recovery period will generate aggregate tax savings over the 39 period due to the NCR Bonuses of 67.4% of its original cost assuming a 5% rate of inflation and 1.316 times its original cost assuming a 7% rate of inflation. Exhibit 4(b) shows that 10 year recovery property depreciated at 150% declining balance will generate aggregate tax savings over the 10 year period due to the combined NCR Bonuses of 15.2% of its original cost assuming a 5% rate of inflation and 19.9% of its original cost assuming a 7% rate of inflation.

Table showing effect of 1.035 factor only on property with recovery periods of 3,5 and 10 years. The calculations assume a cost of $1,000

Line	3-Year Recovery Period	Year 1	2	3	4	5	6	7	8	9	10	Total
1.	200% declining balance depn	667	222	111								1,000
2.	150% declining balance depn	500	250	250								1,000
3.	1.035 factor NCR Bonus[1]		9	18								27
4.	Cumulative 200% declining balance	667	889	1000								-
5.	Cumulative 150% declining balance	500	750	1000								-
6.	Excess of line 4 over line 5	167	139	-								-
7.	**Aggregate extra tax paid at 35% at start of current year for full year**		58.45	48.65								-
8.	**Value line 3 at 35%**		3.15	6.3								9.45
9.	35% tax gross-up (line 8 x 1.54)		4.85	9.7								14.55
10.	**Line 9 as a % of line 7**		8.3%	20%								-

[1] Total neutral cash recovery depreciation adjusted for the 1.035 factor is the amount in line 2 multiplied by the factor shown in Exhibit 2 for a 3.5% inflation rate. Line 3 in each table is the excess of this total over line 2.

Line	5-Year Recovery Period	Year										Total
		1	2	3	4	5	6	7	8	9	10	
1.	200% declining balance	400	240	144	108	108						1,000
2.	150% declining balance	300	210	163	163	164						1,000
3.	NCR Bonus		6.7	11.6	17.8	24.2						60.3
4.	Cumulative 200% declining balance	400	640	784	892	1000						-
5.	Cumulative 150% declining balance	300	510	673	836	1000						-
6.	Excess of line 4 over line 5	100	130	111	56	-						-
7.	**Aggregate extra tax paid at 35% at start of current year for full year**		35	44.5	38.8	19.6						-
8.	**Value line 3 at 35%**		2.34	4.06	6.23	8.47						21.1
9.	35% tax gross-up (line 8 x 1.54)		3.6	6.25	9.6	13.0						32.45
10.	**Line 9 as a % of line 7**		10.3	13.7	24.7	66.3						-

Line	10-Year Recovery Period	Year										Total
		1	2	3	4	5	6	7	8	9	10	
1.	200% declining balance	200	160	128	102	82	66	65	66	65	66	1,000
2.	150% declining balance	150	128	109	92	87	87	87	87	87	86	1,000
3.	NCR Bonus		4.5	7.7	10.0	12.9	16.4	19.9	23.8	27.6	31.6	155.4
4.	Cumulative 200% declining balance	200	360	488	590	672	738	803	869	934	1000	-
5.	Cumulative 150% declining balance	150	278	387	479	566	653	740	827	914	1000	-
6.	Excess of line 4 over line 5	50	82	101	111	106	85	63	42	20	0	-
7.	**Aggregate extra tax paid at 35% at start of current year for full year**	-	17.5	28.7	35.3	38.9	37.1	29.8	22	14.7	7	-
8.	**Value line 3 at 35%**	-	1.6	2.7	3.5	4.5	5.7	7.0	8.3	9.7	11.1	54.1
9.	35% tax gross-up (line 8 x 1.54)	-	2.4	4.2	5.4	6.9	8.8	10.8	12.8	14.9	17.1	83.3
10.	**Line 9 as a % of line 7**	-	13.7	14.6	15.3	17.7	23.8	36.2	58.2	101	244	-

Table showing annual amount to which $1 would grow at various assumed rates of inflation (columns (a),(b) and (c)); and the annual inflation indexing NCR Bonus amount as a percentage of the depreciation deduction without the NCR Bonus (columns (d), (e) and (f))

	Amount to which $1 would grow at various assumed rates of inflation			Inflation indexing NCR Bonus as a percentage of depreciation deduction without any NCR Bonus		
	(a)	(b)	(c)	(d)	(e)	(f)
	Rate of Inflation			Rate of Inflation		
Year	3.5%	5.0%	7.0%	3.5%	5.0%	7.0%
1	0	0	0	0%	0%	0%
2	1.035	1.05	1.07	3.5	5	7
3	1.07	1.10	1.14	7	10	14
4	1.11	1.16	1.23	11	16	23
5	1.15	1.22	1.31	15	22	31
6	1.19	1.28	1.40	19	28	40
7	1.23	1.34	1.50	23	34	50
8	1.27	1.41	1.61	27	41	61
9	1.32	1.48	1.72	32	48	72
10	1.36	1.55	1.84	36	55	84
11	1.41	1.63	1.97	41	63	97
12	1.46	1.71	2.10	46	71	110
13	1.51	1.80	2.25	51	80	125
14	1.56	1.89	2.41	56	89	141
15	1.62	1.98	2.58	62	98	158
20	1.92	2.53	3.62	92	153	262
25	2.28	3.22	5.07	128	222	407
30	2.71	4.12	7.11	171	312	611
39	3.70	6.39	13.08	270	539	1208

Table showing the amount of NCR Bonus Depreciation as a percentage of depreciation deduction without NCR Bonus, combining the 1.035 NCR Bonus and the inflation indexing NCR Bonus assuming various rates of inflation

Year	1.035 NCR Bonus Amount	1.035 NCR Bonus Amount combined with inflation indexing NCR Bonus at assumed rates of inflation shown		
	(a)	(b)	(c)	(d)
		3.5%	5.0%	7.0%
1	0%	0%	0%	0%
2	3.5	7.1	8.7	10.7
3	7	14.4	12.4	14.5
4	11	23.2	28.8	36.5
5	15	32.3	40.3	50.7
6	19	41.6	52.0	66.6
7	23	51.3	64.8	84.5
8	27	61.3	79.1	104.4
9	32	74.2	95.4	127.0
10	36	85.0	110.8	150.2

Table showing aggregate inflation indexed NCR Bonus and tax value at 35% tax rate assuming a $1,000 asset is depreciated straight line over years shown with various assumed inflation rates

Recovery Period In Years	Assumed Inflation Rates					
	3.5%		5%		7%	
	NCR Bonus	Tax Value	NCR Bonus	Tax Value	NCR Bonus	Tax Value
27.5	591	207	988	346	1709	598
39	1070	374	1926	674	3760	1316

Table showing tax value of 1.035 NCR Bonus combined with inflation indexing NCR Bonus at assumed rates of inflation for an asset of $1,000 with a 10-year recovery period

	1	2	3	4	5	6	7	8	9	10	Total
1. Annual 150% declining balance amount	150	128	109	92	87	87	87	87	87	86	1,000
<u>3.5% Inflation</u>											
2. Combined NCR Bonus Percentage, exhibit 3, column (b)	—	7.1	14.4	23.2	32.3	41.6	51.3	61.3	74.6	85	
3. Line 2 times line 1	—	9.0	15.7	21.3	28.1	36.2	44.6	53.3	64.9	73.1	
4. **Tax value of NCR Bonus (35% of line 3)**	—	3.2	5.5	7.5	9.8	12.7	15.6	18.7	22.7	25.6	**121.3**
<u>5.0% Inflation</u>											
5. Combined NCR Bonus percentage, exhibit 3, column (c)	—	8.7	12.4	28.8	40.3	52.0	64.8	79.1	95.4	110.8	
6. Line 5 times line 1	—	11.1	13.5	26.5	35.1	45.2	56.4	68.8	83.0	95.3	
7. **Tax value of NCR Bonus (35% of line 6)**	—	3.9	4.7	9.3	12.3	15.8	19.7	24.1	29.0	33.4	**152.2**
<u>7.0% Inflation</u>											
8. Combined NCR Bonus percentage, exhibit 3, column (d)	—	10.7	14.5	36.5	50.7	66.6	84.5	104.4	127.0	150.2	
9. Line 8 times line 1	—	13.7	15.8	33.6	44.1	57.9	73.5	90.8	110.5	129.2	
10. **Tax value of NCR Bonus (35% of line 9)**	—	4.8	5.5	11.8	15.4	20.3	25.7	31.8	38.7	45.2	**199.2**

Chairman ARCHER. Thank you, Mr. Schapiro.

Let me alert the committee that we are nearing a vote on the floor on the Barton constitutional amendment, so when the bells ring, we will continue for about 5 minutes with our inquiry and then we will break to go vote. We will return after the vote. I hope that our witnesses will bear with us and stay with us for the completion of the inquiry period.

There are many, many things I would like to ask you, but I think I am going to defer to the members of my committee at this point. I am going to recognize and yield to Mr. Bunning for the first inquiry.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Usher, I would like to ask you some specifics. You mention AMT increases your cost of capital. Do you ever take AMT into consideration when deciding whether you should or should not make a capital expenditure?

Mr. USHER. We do. When we look at any type of investment, we have to be able to recover this cost, or it doesn't make sense for us to do it. And we have a list of things we would like to do that is a lot longer than the money we have. So quite often, we find ourselves deferring projects because they just don't provide a sufficient return to us.

However, if we had relaxation of the AMT, where we would be able to have capital expenditures depreciated, for example, over the same life as the regular corporate tax, there are investments that we probably would make that we currently don't make.

Mr. BUNNING. Mr. Sigler, why does the forest product industry seem more susceptible to the problems with the alternative minimum tax than some others?

Mr. SIGLER. Probably—first of all, we are very capital-intensive. In other words, it costs us more money to put in a pulpmill or paper machine for what revenue we would get as compared to other manufacturers. We are the largest in the world. We produce a basic world commodity and our prices swing up and down with the economy.

Our prices are almost auction prices. So we can end up with very large depreciation deductions in relation to our income, especially during a recession. Let's take the last 5 years where Champion spent $5 to $6 billion. We ended up with large AMT payments even though we broke even or incurred losses under normal financial accounting standards.

So AMT kicks in and the way it works, we add back as income what is called a depreciation preference item and then pay tax on it at a 20 percent rate. Grossly oversimplifying, but for us that is a cash out at a time when we can least afford it. Maybe we drive the prices up and down a little more violently, but it is those things that work together.

Mr. BUNNING. In your testimony, you suggested two changes in AMT, shorter recovery periods and a faster use of the AMT credit.

Mr. SIGLER. Well, you know——

Mr. BUNNING. Which one would you like first.

Mr. SIGLER. We would like expensing. And if you really get down to us, we think that those of us who are essentially in business to build things and use money, we think we should be able to expense the same as others do their advertising and research and development budgets.

Short of that, my personal feeling is we ought to get rid of the AMT. It makes no sense. It was brought in to address a leasing problem in 1986 that doesn't exist today. Congress never intended for the AMT to trap companies and keep them permanently paying a higher rate of tax than under the regular tax, yet that is what it does today.

Short of that, I support recovering the investment faster. It takes us about twice as long to recover our investment than under the regular tax. I agree with Tom's comment we look at how fast we can recover cash in an investment and so I think improved AMT depreciation by shorter recovery periods would have the greatest effect on new investment.

Mr. BUNNING. Mr. Entin—this will end my questioning—when Assistant Secretary of Treasury Samuels was here, he argued that the neutral cost recovery might lead us to new tax shelters. Please respond to that for us, if you would.

Mr. ENTIN. Treasury always likes to match income and depreciation recapture, and tries to balance these things off over the life of a project. But very often when a firm has a new project or new product coming out, it doesn't achieve sales and revenues until some time later, but it takes some deductions immediately.

Treasury has gotten to the point where they say any time you have a deduction now that is bigger than your current earnings on your project, that is a tax shelter. That is nonsense. The term used to mean that somehow the writeoffs for a project over the life of the project were bigger than the cost of the project. And you could get something like that back in the bad old days when you had nonrecourse loans and you really did not have that much money at risk or back in the days when the investment tax credit might have been so big that it overcompensated for the underdepreciation in the depreciation schedules and you were giving companies back more than they were investing.

But to say that because in the short run a particular product might not have gotten into the market yet, and meanwhile you are depreciating some of the equipment, that there is a tax shelter, is outrageous. That is not what a tax shelter means. You have to look at the whole life of the project. Neutral cost recovery only allows a business to write off the full present value of the cost. It doesn't allow it to write off more than that.

There have been some concerned comments by the Treasury about interest and the lack of adjustment of interest and debt for inflation. There were comments here today. I think that is a mistake. The tax treatment that we give the purchase of a piece of equipment and then the earnings of that equipment is the tax treatment that applies to the actual economic activity of the firm. How the financing is done is something quite separate. A firm should be allowed to deduct the interest that it pays to the lender because the lender is being taxed on the interest. The two are a wash, and the debt financing is treated for tax purposes the same as internal financing. There is no shelter there. There is no distortion there. If we went all the way to a full-blown consumption tax like Nunn-Domenici or Mr. Armey's bill or Mr. Archer's approach, one would not have to worry about the interaction between the borrower and the saver. For example, in the Nunn-Domenici bill, the saver would get a deduction for his savings and pay tax on the interest, and then the borrower would not need to be given a deduction.

But if you were not to give the saver his deduction for his expenses, or you were not going to exempt the saver from having to pay tax on the interest, then to tax the interest at the saver's side and the flow of capital at the business side is to double tax that income.

So this complaint is something which simply suggests that Treasury might be telling you either A, "We don't like the bill and we are coming up with excuses," or B, "You really ought to go the whole distance and solve this saver-borrower problem in addition to the depreciation problem."

Well, I don't think they want you to go full-blown reform. I think they are just making an excuse. In a full-blown system you would address the saver's problem, but it doesn't mean that you cannot handle the businesses' depreciation problem in the meantime. That is independent and should go forward.

Chairman ARCHER. The gentleman's time has expired.

Mr. Gibbons will be our last inquiry.

Mr. GIBBONS. Wouldn't it be simpler, better for all of you—as long as we cling to this old income tax system—if we just simply went to an expensing system on purchases of assets?

Mr. JORGENSON. I would like to respond to that.

I think that is exactly right. And I think that is precisely why it is very important for this committee to look at the neutral cost recovery system as essentially one element of a transition to a consumption tax.

Now, the key things you, and as Chairman Archer and others have pointed out in this committee many, many times, is the transition problem of going from an income tax system to a consumption tax system. The problems that are involved are formidable, as you just heard. And I think that is something that needs to be addressed. But I think the way to look at the neutral cost recovery system is that it is potentially one element in that transition to a consumption-based system.

Mr. GIBBONS. You would rather have expensing than any of the gimmicks we come up with here though, wouldn't you?

Mr. JORGENSON. Well, expensing involves a tremendous revenue loss, Mr. Gibbons. We have to address issues of the budget agreement and the deficit that have been brought before this committee. And in the process of the transition, those issues are going to have to be addressed. But in the long run, if you think about where the Tax Code ought to end up, yes, we ought to end up at expensing and we ought to take the other steps to eliminate tax deductibility of interest and the other things that have been discussed here to produce a completely neutral Tax Code. That should be our objective in the long run.

Mr. GIBBONS. Thank you.

Chairman ARCHER. Thank you gentlemen.

We will recess now to vote and we will come back as soon as possible. If you will indulge us and remain, we would appreciate it.

[Recess.]

Mr. BUNNING [presiding]. Our guests will take their seats, please.

Mr. Houghton will inquire.

Mr. HOUGHTON. Thank you.

I thank you gentlemen for being with us. I am sorry for the interruption, but I guess you understand the reasons.

I would like to ask a question to anybody, but particularly to Mr. Usher and Mr. Sigler.

I happen to agree with you on the alternative minimum tax. We have got to do something about this and I appreciate your comments. I would like to talk about the main focus of this hearing which is the neutral cost recovery.

Neutral cost recovery is really expensing on a present value basis. And the problem is this: That it is backloaded so you get a lesser depreciation today and a greater one later on. And also probably in the process you don't trust it. I mean, the government will get the benefit earlier on, and yet when the pinch comes, this thing will change.

So that is one problem. Now another problem, of course, is if you don't change that, and if you do keep it in place, you almost cannot do this thing alone. It is so generous, there is so much money, as a matter of fact, you probably could get into the same pit we got into before, where people were borrowing to put up buildings or to buy equipment which they didn't need because the advantage was so great. It is a huge impact.

So, the answer to that might be—and I am sure there will be great howls here—to eliminate the deductibility of interest. So you are really between a rock and a hard place here, and I would like your comments on it.

Mr. USHER. Well, I recognize the problems that you have mentioned. And what I would say is that, while certainly a lot of the concepts in the NCRS are appealing to us, we find ourselves—and I think this is unique to a lot of manufacturing businesses that are very capital-intensive, cyclical, and that must compete in a world market—the problem we have is that the technology in our business changes quickly.

We need to continue to invest. And in the steel industry, for example, we are going through a whole phase of new technology. We are either going to invest in this or we are going to be left behind, and the steel needs of this country are going to be supplied by Japan, Korea, Italy, or whatever. We need to have a system that allows us to quickly recover that capital.

Now, probably from our perspective, the easiest way to accomplish that would be to just reduce the AMT life down to the same as for regular taxpayers—7 years instead of 15 years. It would be relatively simple and allow us to continue to invest in this business.

Absent that, we are going to see, I think, a continually eroding manufacturing base in this country. And I strongly feel that, while there is a great move to go to high technology, the manufacturing base in the United States is important. In addition, these high-tech producers sell to us. They can only sell so many home computers. They have to sell to us.

So I think from our perspective, we recognize the problems with NCRS. We think Congress' appreciation that businesses, such as ours, need to recover their capital costs quicker is important. I guess our preference however, would be toward proposals that would allow us to reform the AMT. Most of the members of AISI are in a permanent AMT position. They are not going to get out of it and that is really where I think the emphasis needs to be directed.

Mr. HOUGHTON. Maybe rather than going through all of these contortions, it would be a better idea simply to take an expensing approach?

Mr. USHER. I certainly wouldn't argue with that.

Mr. HOUGHTON. How do you feel about it, Mr. Sigler?

Mr. SIGLER. Well, expensing is what we would really like. And I think that probably the fault we have is we come down here and we try to take into consideration what can be done and the things that are really yours to decide. I speak from a position of a company that has capital as its basic raw material. It is not development, it is not advertising, it is not people. It is capital. Expensing is the ultimate way of getting your money back and being able to use it again. We run our businesses off of cash flow.

And so I agree with Tom. If you look at what is the thing that bothers us most now, it is AMT. A lot of dollars that we could reinvest to create new jobs are tied up at the Treasury in excess taxes we are paying due to AMT. It is a lot of dollars.

Mr. USHER. We would also favor expensing. It is the practicality of it. So many other costs are expensed, it makes sense to expense these type of costs also.

Mr. HOUGHTON. Are there other comments that other members of the panel would like to make on this?

Mr. ENTIN. Expensing has the up front cost. At Treasury, you are going to get the same howling about interest and about tax shelters in a far more virulent form if you try expensing on them. That is not really the issue. Both of those complaints by Treasury are invalid.

Remember, the problems back in the sixties and the eighties came from an ITC that was too generous or nonrecourse loan problem. It did not come from the accelerated depreciation itself.

Mr. HOUGHTON. Thank you.

My time is up, thank you very much.

Mr. BUNNING. Mr. Zimmer will inquire.

Mr. ZIMMER. Thank you.

Professor Jorgenson, you said for purposes of equity and symmetry it would be appropriate, if we expensed the cost of equipment or went to net neutral cost recovery, for the interest costs of the taxpayer to be nondeductible. Have you looked into the practicalities of achieving that and how you link specific interest payments to a specific purchase and a specific piece of equipment? Is it possible?

Mr. JORGENSON. Mr. Zimmer, as I suggested, I think that the neutral cost recovery idea is a very good one, but it really has to be viewed in the context of the whole Tax Code, and in particular, it has to do with the issue that you just raised. And it seems to me that the only way to do that is through a comprehensive reform aimed at shifting the base away from income toward expenditure. And within that context, obviously, eliminating interest deductibility would be an important element.

There are two proposals that are going to be before this Congress. One, the Armey flat tax proposal which was discussed in the last Congress. The other, the Nunn-Domenici proposal which has also been discussed, and both of them move in this direction and involve eliminating the deductibility of interest. So I am not proposing that one ought to look at neutral cost recovery and the elimination of interest expenses in isolation from the rest of the Tax Code. I think that you really have to look at this as part of a comprehensive reform.

Mr. ZIMMER. Logically speaking, you would have to go to the next step and say that the lender won't recognize any income.

Mr. JORGENSON. Right. As you realize, many of the lenders in this economy are people who are in a tax-protected position—people who essentially don't pay tax or they pay a modest amount of tax. Otherwise, it doesn't pay to clip coupons on bonds. So many of the securities that we think of as debt, in the sense that is used in the Tax Code, are securities held by lenders who are themselves not taxable. That is what creates the opportunities that we have been discussing for tax shelter and why an approach in isolation would not be a satisfactory one, in my view.

Mr. ZIMMER. Mr. Entin.

Mr. ENTIN. If you went all the way to consumption-based tax treatment, as for example in Mr. Armey's bill, the individual would not get a deduction for his saving, but he would not be taxed on his interest.

If you get rid of the deduction for interest at the corporate level or business level without simultaneously adopting something like the Armey approach to exempt interest at the lender level, you would be double taxing the interest in much the same way we double tax dividends.

The current treatment is correct if the lender is taxable. The borrower's interest deduction and the taxation of the lender's interest should both come off at once, or the interest deduction should remain until we go that extra route and eliminate the taxation of saving at the lender's level.

The only time you run into trouble is when you are borrowing from a charity or some other tax-exempt entity. But that distortion is not due to the way we treat business borrowing or the way we treat purchases of supplies and equipment. It is due to the fact that Congress said that charities shall be tax exempt. And they are exempt on their income whatever the source. If a wage earner takes wages out of his paycheck and gives it to the charity and takes the charitable deduction, the charity doesn't have to pay taxes on that income. Or the charity's income may be interest on a savings account or a government bond or a corporate bond. You shouldn't be altering the tax treatment of businesses because you have given a certain group of individuals in the economy tax-exempt status on any income they might get.

Mr. ZIMMER. We are running out of time, but I would like to put a flat question to all the members of the panel, once again comparing up front expensing to neutral cost recovery.

Do you see significant differences between the two proposals in terms of their macroeconomic effect and in terms of their long-term effect on Federal revenue disregarding any particular budget window?

Mr. CHRISTIAN. Mr. Zimmer, I think that expensing would be the preferred alternative. I think that is generally agreed. People think it is not impractical—that it is not practical. But let me make a point that it is merely a timing change.

NCRS gains revenue in the first 3 to 4 years as you know. It then loses a very large amount of revenue later on. Now, conversely, if you went to expensing for equipment placed in service in 1995 and thereafter, that would create significant—I don't know the number, but significant revenue losses for a number of years. Perhaps five. Don't hold me to that exactly. But expensing turns around very quickly relative to present law and starts producing, relative to present law, gains in the outyears.

And you have to think about that and it is very interesting in the context of trying to reach a balanced budget by the year 2005. You might find that expensing beginning in 1995 could fit better into that pattern than NCRS does, because the goal is a balanced budget in the year 2002, not a balanced budget in 1998 or 1997.

Mr. BUNNING. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Let me again thank the panelists. I think this discussion has been extremely useful and helpful. There appears to be certain agreement among all of you that the preferred route would be to expense. But we all know that as a practical matter is not what we can accomplish in this cycle, that we are not—we don't have the revenues on our scorekeeping and it is not practical.

Mr. Houghton raised some very interesting points about the neutral cost recovery system, and the potential costs to the Treasury. Mr. Shapiro has pointed out, I think, very well, that based upon what happens with inflation, we could have some very serious problems of freezing assets that are relatively old. And that could cause a problem.

But let me just raise what I think is the most serious problem, practical problem with the neutral cost recovery, and that is we are going to argue as to the costs. We are going to argue as to the economic assumptions.

There are going to be those who say that it will produce all types of economic benefits and, therefore, we should use dynamic scoring and not look at these outyear costs. There are going to be others who disagree with that and we are going to spend more time arguing over the economic assumptions and there is going to be a lack of confidence that we know what we are doing. And I would suggest that it is just not going to move forward.

On the other hand, dealing with the alternative minimum tax, we know what we are talking about. We know what impact it is going to have. We know what revenues it will in the short term cost the U.S. Treasury, and we can at least work off the same song sheet on AMT.

Now, we could maybe disagree as to whether this is an interim step or a final step, or whether we are moving toward expensing. But I would hope that, as we did in 1993, in making some progress on the depreciation base, that we could try to develop priorities to make progress in this go-round. And it seems to me that the most practical, pragmatic approach is for us to deal with AMT first, rather than trying to argue over the economic assumptions of the neutral cost recovery system, which at best most businesses see as an interim step toward expensing.

I would appreciate your thoughts about it. It seems to me that we could come together on AMT, although I don't think we can on this neutral cost recovery, though that is just my observation. Does anyone wish to comment?

Mr. JORGENSON. Mr. Cardin, I think this committee really ought to proceed on each of these tax proposals within a framework in which the overall impact is neutral so far as the government budget is concerned. That was the approach that was taken in 1986.

I think that proved to be a very, very fruitful tack. That was an approach that led to what I believe to be the greatest achievement, as I said a couple of years ago, of this committee in this century, the 1986 Tax Act.

And I think that, therefore, pursuing your line of reasoning, rather than get involved in a lot of detailed discussion about dynamic and static scoring and that sort of thing, one ought to consider in this committee's proposals in an overall framework of revenue neutrality. If someone is coming up with a revenue loss of something that you have discussed or that the Treasury has put before us, one really ought to consider that in the face of other changes that are going to produce revenue gains.

Mr. CARDIN. I appreciate that. Of course, the $120 billion over the 10-year period that the Treasury has come up with for the neutral cost recovery, is an amount that it is going to be extremely difficult for any of us to agree to fill that void.

Mr. USHER. If you could do one thing in the near term, I think that lowering the tax life for the AMT taxpayer down to the normal taxpayer life would probably be as significant a change as you could make to help, and this would help an awful lot of basic manufacturing companies in this country.

Mr. SIGLER. I find it very stimulating to talk about all these cost recovery options, but from a practical point of view, the only thing that governs most of my life, is AMT. And it is the one thing I would consider negative to the company and to the economy.

Mr. ENTIN. It would be correcting an abuse that hits the AMT people harder than other people are hit by the current tax law. You wouldn't be doing anything to help the people that currently are not being hit by the AMT. Concerns about the inadequacy of static revenue estimation apply equally to AMT and to neutral cost recovery. Adopting NCRS and fixing the AMT both have outyear revenue effects that would appear less alarming with dynamic revenue estimation. Look at the outyear revenue effects. Within 10 years, Federal revenues will be, roughly, $2.4 trillion. Treasury is estimating that neutral cost recovery would cost $28 billion in the tenth year, which is 1 percent of revenue. If we get 1 percent additional growth of GDP out of this proposal, it ought to pay for itself.

Mr. CARDIN. If we correct AMT, we are going to have more unity in working toward expensing.

Mr. BUNNING. Ms. Dunn will inquire.

Ms. DUNN. Thank you very much, Mr. Chairman. I am sorry for the interruption.

Gentlemen, apparently Mr. Sigler, the questions I would have proposed to you having to do with the forest products industry and the particularly onerous effect on that industry of the AMT have been asked. I will simply look to the record for that and won't ask you to be repetitive, but I do want to ask you to apply some things to the creation of jobs in a State like my State, Washington State. How would improvements in depreciation under the AMT affect jobs?

Mr. SIGLER. I think you have to look at the company's general strength, cash flow determines what you have the capability of doing. If you can recoup the cost of an investment, for cash now, then new investments can be made. Cash flow is really what governs the ability to put in a sawmill or two or to make the large capital expenditures to improve a pulpmill or put in a new bleach plant. Those are the kinds of investments that create high-wage jobs, and provide economic growth and they are made based upon your ability to do it—cash flow.

When our costs are not recovered for 13 years, our decision to make new investment is much more dependent on the availability of cash flow than on what the total dollar cost may ultimately be. Because when you are in our kind of crazy business where the prices go up and down 100 percent each way, you don't make a capital investment that is going to take you 5 years to bring on line on, based whether it is 14.6 RDCI or 15.3. You make a lot of judgments and the most basic judgment is, can I pay for it? Cash. Not financial accounting, but availability of cash.

Ms. DUNN. Thank you, Mr. Chairman.

Mr. BUNNING. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman. I don't have any questions.

Mr. BUNNING. Mr. Rangel will inquire.

No questions?

Mr. Jacobs.

Mr. JACOBS. Mr. Chairman, the good news is I have no questions. The bad news is that Mr. Ford asked me to read two questions, and I agreed to do so. So, you cannot win for losing.

In summary, I think—now, let's see, Mr. Entin, I think he wants to direct this to you. Your summary of testimony states that the committee has curtailed the NCRS adjustment for long-life property and for structure. In fact, this committee has taken no action with response to NCRS. Are you referring to changes in the so-called Republican Contract and do you regard them as major changes?

Mr. ENTIN. I read in the papers that you were considering a version that would not apply full NCRS treatment to structures and longer lived assets, and I had thought that earlier versions did include them. If I have the timing of the change wrong, I apologize. But I wanted to make the point that the longer lived assets don't get the full treatment.

Mr. JACOBS. My mother thanks you, my father thanks you, but especially Mr. Ford thanks you.

The second question is for Mr. Schapiro. I believe that you are arguing that the neutral cost recovery system would create an incentive for taxpayers to keep property in service in order not to lose the ever-increasing depreciation deductions. Do you agree? And how would this phenomenon affect economic growth?

Mr. SCHAPIRO. Do I agree with that? Yes, but that is presumably not the question to me.

Mr. JACOBS. I have no authority to play favorites.

Mr. SCHAPIRO. I think that, yes, it seems to me that inevitably there is a tax credit which is provided for property as it remains in service. And the simplest case is real estate on straight line depreciation. Each year it is around, it just attracts this credit. It is just a tax benefit. It doesn't do anything else. And it doesn't reduce basis. So I would think there would be an incentive to keep these things around to keep the tax credit rather than sell it to somebody else who can use it.

Mr. CHRISTIAN. I would not agree with that, actually. I think my friend, Mr. Shapiro, is classifying the inflation adjustment and the interest adjustment as bonus depreciation. I would not classify it that way. The purpose of the inflation adjustment is simply to compensate the taxpayer for the adverse effects of inflation.

The purpose of the other adjustment is simply to compensate for the postponement of a deduction. I fail to see how that is a positive advantage that causes me to keep property around. Perhaps I have missed something.

Mr. JORGENSON. Mr. Jacobs, I would like to address the question that was left hanging, the impact of a proposal like this on economic growth. I think that is a very important issue. And although I tried to address it in my remarks, I didn't have a chance to give the details that are relevant.

First of all, I think that Ms. Dunn has raised a very important point here. What is it that we are trying to accomplish here?

The answer is that we are trying to increase the productivity of workers. That is what creates jobs, making workers more productive. That is true of paper. That is true of steel. It is true of high technology in this country, including the much despised service industries.

In order to do that, you have to use capital. The issue that tax policymakers must face is how to use capital efficiently and the purpose of a neutral system is to make sure that every dollar of an investment produces the maximum impact on productivity. Now, I suggested before that the impact of the last attempt at tax reform did increase neutrality and did produce a substantial contribution to economic growth. I estimate that to be, roughly, $1.25 trillion.

Moving to a system of completely neutral cost recovery, based on the idea of expensing would double that gain. In other words, the impact on economic growth would be another $1.25 trillion, something comparable in magnitude to the Federal budget.

So my conclusion is that we ought to talk about the impact on growth. That is what we are here to discuss. And a neutral cost recovery system has a great deal to contribute to economic growth.

Mr. JACOBS. And now the good news is, Mr. Chairman, I yield back the balance of my time.

Mr. BUNNING. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

And I thank each of you for your testimony. I have enjoyed listening to you, especially about the alternative minimum tax.

Mr. Jorgenson, I disagree with you about the 1986 Tax Reform Act being one of the best things that ever happened to this country. I believe that act led to the 1990 Tax Reform Act and the 1993 Tax Reform Act. And if we don't do anything, we are going to face a similar tax increase in the next 2 or 3 years.

Mr. Usher, you mentioned the fact that there are a lot of jobs that are being created today but they are low-income jobs, low-wage jobs. It was mentioned earlier the fact that we are facing a high employment rate, a low unemployment rate but a lot of them are those low-wage jobs. It takes two low-wage jobs to equal one of the jobs that comes from manufacturing and your industry. But that brings forth another situation. Low-income wage jobs qualify 35 million families for the earned income tax credit. So for every job that we can create on your side, we eliminate those type jobs over there—we are never going to eliminate them all. They are needed and they contribute, but we eliminate the need for the application and qualification of earned income tax credit which is a drain and transfer of funds from the Treasury.

A lot has been said about expensing. I thought depreciation in interest on cost sheets were supposed to equate out to the cost of equipment. Expensing all in 1 year would throw a disruption into the cash flow of the taxpayers' bank account, which is the Treasury.

But depreciation and interest is supposed to equal your cost or a company's cost of equipment. That is how you recoup your cash flow. But based on the current depreciation schedules linked with the alternative minimum tax, is it not true that you can actually pay tax, that you are paying tax, and that many companies are paying tax on the cost of equipment?

Mr. USHER. I would say for the large majority of the companies, the steel companies that are associated with AISI, that many of them are paying taxes while they are, in fact, in a loss position. And the thing that drives them to that situation is the fact that the length of the depreciable life for steel assets is twice what the normal rate is. So, in fact, instead of depreciating over 7 years as the normal taxpayer would do, they are depreciating over 15 years and, as such, while they would not be a taxpayer under the normal calculation, under the AMT calculation—while losing money—they are still paying taxes.

That tax money is money that could be used for investment in equipment. And it becomes a death spiral. You remain locked in an AMT status and you never get out. And that is why one of the recommendations that I would strongly make would be to shorten that depreciable life. This would allow you to recover the cost of that investment over the same period of life as a normal taxpayer.

And this business is no different than most other businesses. The technology is moving so fast that you have to keep investing in business. It is like being on a treadmill. If you stop, you are going to be left behind when measured by a world standard. And if you want to be world class, you have got to keep investing in the business. And that is the problem with a lot of the steel industry, and I think it is true in chemicals and refining and paper and many basic manufacturing capital-intensive businesses—you have got to keep investing money. These people tend to find themselves in an AMT position and, once there, they are not able to generate sufficient cash flow to keep reinvesting in the business.

Mr. COLLINS. One other point: Mr. Shapiro, you mentioned the fact that a lot of companies may freeze assets instead of replacing them. How would that affect the economy?

I think it would affect the economy where equipment is held longer. There would be less need of production or manufacturing or assembling of that equipment. For example, a truck: If you rotate your truck on a 4-year basis, but yet due to encouragement or incentives, you keep it 8 years, then there are less trucks manufactured, less jobs needed for the assembly lines. I think the creation of jobs is the ultimate goal that we are trying to get to.

Mr. SCHAPIRO. Yes, I think that the incentive to freeze assets is a lot less for shorter term assets than it is for longer term assets. I was really thinking principally of assets that would go out 10, 15, 20 years. The question is do you just retire them or leave them alive merely to get the tax credits and maybe not sell them to someone. And they don't have to produce income, they are just tax credits, and that is all they do and they are valuable for that purpose as long as they are in service.

This is something extra. There is a check from the government under this system. And it seems to me that people would be inclined to do that rather than put them out of service. They would just leave them stacked up. It is pure economics if you look at the numbers. And I think the cash flows out there would so indicate. This is not to say that you might not buy new ones, too, you might well. But why would you get rid of anything? It just sits there and generates credits.

Mr. BUNNING. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman.

I want to thank this panel. This has been a good discussion concerning the neutral cost recovery system that certainly I have learned from.

I just have a question, and it is really for Mr. Usher and Mr. Sigler: Before I ask the question though, I would like to frame it just in a context. The New York Times on Tuesday had an article about this very system, and in the article, they said business executives worry that they would forgo some deductions in the early years only to have Congress change the law so that they never get the promised writeoffs. The president of the National Association of Manufacturers, Jerry Jaznowski, then is quoted saying there is some element of trepidation about buying a plan that you think may be changed in the long term.

We are now voting on a balanced budget amendment, and likely it will pass. We will be then in a position where we will need to find $1.2 trillion in deficit reduction between now and the year 2002. All the tax breaks that are in the Contract With America add another $400 billion to that. We will then be looking at $1.6 trillion. I think it is likely that many issues will be looked at in the next few years as we try to accomplish that objective. Certainly this will be one of those issues.

So my question is, then, as you look at and think about this proposal in the light of what seems to be going on in terms of public policy, does it concern you that this might be somewhat speculative in that you might be required to give up something early on and find that you don't really reap the benefits?

I know that you are now under the alternative minimum tax so you are not affected anyway, but assuming that you were looking at this as a company that was looking for these benefits in the future.

Mr. USHER. I believe it is true that about 80 percent of the Federal revenue really comes from individuals' tax receipts. It seems to me that the thing that should be foremost in policy planning is the ability to create jobs for Americans who are going to become taxpayers.

As we look at different alternatives and how we can achieve this, we should certainly take into account the effects on the economy as a whole and the ability of businesses that want to invest money and build factories and build plants and make capital investments so that jobs can be created.

Absent increased investment in the U.S. steel business, 20 percent of the steel brought into this country will continue to be imported, and it will be made by Japanese, Korean and European steelmakers, and they will be paying taxes to Japan, Korea, and the European countries that they live in. I think from a national standpoint, it is much better to provide that type of mechanism that allows businesses that want to invest to invest, create jobs, and maintain jobs where taxpayers are paying taxes.

Mr. PAYNE. Let me say I agree with that, but I think the question really is, from a business perspective, do you think this is more speculative perhaps than other ways it might be structured to make it somewhat less speculative, such as changing depreciation schedules, AMT changes, and other such alternatives.

Mr. SIGLER. Maybe one way of looking at it is we have to spend money every year, and we determine how much we can spend based on our cash flow. That is, by the general strength of the company and the cash flow that it will generate. So if we say we can spend $700 million next year, we then have to choose which projects to go forward with. We have so many things we have to spend money on to fix, we have so many things that we want to spend money on for profit improvement, we have so many things we want to spend money on for expansion. The rate of tax depreciation will be factored into what our cash flow is and how much we will be able to spend. Since AMT is our primary tax system, any improvement in that depreciation system will get factored in and enable us to generate more cash flow.

Do we look at what the capital will cost 5 or 6 years out? Not really. You know, that is a very personal thing because I might have people in business disagreeing with me. I don't think we look at what the cost is for long term—you know, I have been doing this job for a long time, and what that cost is from the tax side has changed numerous times over the 20 years I have been in this job.

We can't anticipate what changes will occur in the Tax Code over the next 5 years, but we know it will change.

Mr. PAYNE. So you are motivated by——

Mr. SIGLER. The speed with which we recover the money we invest.

Mr. PAYNE. Recovery of the money and very little of it has to do with whatever the changes are in the Tax Code?

Mr. SIGLER. Within reason. I mean if we are talking about moving the Tax Code a percent or so over so many years, we would look at it as that might affect our cash flow. But how fast we recover the cost is a much bigger factor in my mind.

Mr. PAYNE. And the AMT is important because you can see an immediate result as it relates to your cash flow?

Mr. SIGLER. AMT just puts such a clamp on cash flow that everything else is affected too. It makes all of the other discussions of what are accelerated this or accelerated that irrelevant. AMT is a flat 20 percent we pay, no matter what, taking away the benefit of accelerated depreciation. For a capital-intensive business, that is a great big number.

Mr. PAYNE. Thank you.

Mr. BUNNING. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

I have a couple of questions as they relate to AMT. Mr. Usher and Mr. Sigler, can you amplify on the testimony you have already provided to this panel with regard to the impact of the AMT on the competitive position of your industries.

Mr. USHER. I think when you are an AMT taxpayer and you look at a life of 15 years, it puts you on an international scale at the bottom of the pack in terms of capital recovery. You go around the world and there is no one that has a life that is that extended and yet, the equipment that you use to make steel, regardless of where you make it, is the same. So compared to a steel business a country that can recover this cost in 3 years, 5 years, or 7 years, AMT taxpayers in the U.S. steel business, which most of us are and where it takes 15 years, are put at an international cost disadvantage. In addition, because these costs are the same as the costs of energy or labor or whatever, and you have to add them up to make up total costs, it really puts us at a great disadvantage.

Mr. SIGLER. I think maybe the best way to show that we are at a competitive disadvantage because of AMT is to look at the amount of accumulated AMT credits we have because we haven't been able to use regular tax depreciation deductions. It is well in excess of $200 million that we have paid the government rather than investing in people and equipment.

Mr. ENGLISH. Both of you represent industries that have seen a considerable impact from the Clean Air Act and its regulations. I was wondering if you could comment on the combined effect of the Clean Air Act regulations and the AMT in terms of the excess burden it places on you.

Mr. USHER. Again, we feel very strongly that pollution expenditures certainly should be expensed. Just as a rough estimate, at U.S. Steel, we spend about half of our capital budget, which ranges from $300 to $400 million a year—about half of that just to keep the place going at its present level of capacity. We spend about 25 percent of our money for pollution equipment and about 25 percent for modernization and growth.

That 25 percent is a significant amount, $75 to $100 million some years, and you know, we get nothing out of that from a competitive standpoint. It needs to be done to comply with the law and we do it. But again it is something that, when you are competing internationally, it is a cost that you incur and, when you have to depreciate that over 15 years, it adds that much more to your inability to compete.

Mr. SIGLER. Our numbers are remarkably similar. I would say that between 20 and 25 percent of our capital expenditures would go to some form of environmental—I can't split it between water and air, but, I know that a good portion is for air. We might argue on the margin of parts per quadrillion whether you have to do this or have to do that, but essentially we have to spend a great deal on environmental and I would just second Tom's comments.

Mr. ENGLISH. Thank you.

Mr. Entin, welcome again. I appreciate your appearance for a third time before Ways and Means and its panels. As you are probably aware, earlier in the week Assistant Secretary Samuels testified before this panel and trotted out the argument that the neutral cost recovery system would create some tax shelters that might be an inducement for perhaps a lower use of capital than might otherwise be appropriate. Do you think these concerns are legitimate and, if so, how would we address them?

Mr. ENTIN. I don't think they are legitimate. I think he is thinking back to days when you had an overly generous investment tax credit and the total reward for investment was greater than the cost of the machine. I think he may be thinking back to the days when you had nonrecourse loans and people were being given very large writeoffs when they only had a small amount at risk. These are things that have been corrected. I don't think they apply to the modern Tax Code.

If he is merely saying that we are not double taxing capital as thoroughly as we normally do in the ordinary income tax, then I think that is not the right way of defining a tax shelter.

If I may on your time make a comment about a previous answer.

Mr. ENGLISH. Yes, I was going to follow up on that.

Mr. ENTIN. Thank you.

Many companies do look chiefly to their own cash flow for financing before they decide to buy property, but many other businesses borrow to buy property when it is very worthwhile obtaining that property. Many businesses issue new shares of stock when it is very worthwhile to obtain that property.

I don't think we can just say that only a tax provision that immediately increases the cash flow to a firm is going to help investment. NCRS is not just a minor one- or two-point change in the tax rate; it is something like a 16-percent cut in the cost of capital. Most firms do look at something that big and say, "Gee whiz, we could even issue a whole new bunch of shares and build two new profitable factories." NCRS is enough to get the country moving.

Second, a lot of firms aren't in the AMT hole. Granted, AMT should be fixed because it was an atrocious piece of legislation, but you also need to do something to encourage growth for the rest of the economy as well. You are going to want to have a reputation for enacting tax changes that get people back to work all across the economy, so you do have to do something in the Contract With America to benefit all the industries, not just some of them, if you really want to show results.

Mr. ENGLISH. And I have noticed one of the things you have particularly strongly expressed is on the need to raise expensing.

Thank you very much, Mr. Chairman.

Mr. BUNNING. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I just have to start with an aside. If you were here earlier by a comment that was made, and we have heard it almost on a daily basis from the other side, that one of the biggest ways we can free up capital is to make sure that we don't have a deficit. I just think that is kind of funny that the people you hear arguing against the balanced budget amendment are also the other side. But let's just put that aside for now and talk about neutral cost recovery.

My question is, to start with you, Mr. Entin, and we have heard these arguments about indexing for inflation, address indexing the debt for inflation. We have heard arguments that that would be the only way to make it fair.

Mr. ENTIN. Indexing the debt is an entirely different situation. That is not something that is of concern to the Treasury vis-a-vis the tax treatment of the capital. You have a borrower and a lender, which gets back a little bit to what Mr. Gibbons was saying earlier. Suppose there is 3 percent inflation, and a borrower and a lender have agreed on a 6 percent interest rate, and they make sure the loan and interest is being paid. Suppose 5 years down the road suddenly there is a burst of inflation which erodes the value of the principal. If it were a short bond or a note it would be rolled over. But this is a 30-year bond, so the lender is stuck with a 6 percent interest rate with an eroding principal, and the borrower is saying, "Gee, this is terrific, I am making out like a bandit." That is an equity issue that is between the borrower and the lender. It has nothing to do with the Treasury because the borrower is getting to deduct 6 percent interest and the lender is paying tax on 6 percent interest, so that is a wash. It has nothing to do with the Treasury. It really is an irrelevant argument vis-a-vis neutral cost recovery, and should never have been brought into it by the Treasury.

Mr. ENSIGN. Mr. Schapiro, would you like to address that.

Mr. SCHAPIRO. It seems to me there is an issue from the point of view of tax equity. Take the extreme case where someone acquires property by borrowing and then leases it. Now, that person really is fully protected, assuming that it is debt financed, against inflation I guess what people are saying is this: Is it right to give a person like that a tax benefit reflecting inflation on the asset when that person is protected against it, because that person has debt outstanding.

Yes, he made the deal with the lender, that is true, but in a tax system you ask is it a right thing to do to say that someone ought to get an inflation protection in a case when that person is not subject to inflation.

Now, much of what we have heard today is about people using assets in their own business. In an active business that may be one thing, but when you think about the application of debt financing and leasing, which it certainly would go through in any competitive economy, you begin to see the sort of inequities that people say are associated with getting a benefit for inflation on an asset on which the taxpayer doesn't have the inflation risk.

Now, people may say that is a great deal that taxpayer made by borrowing the money. But in a question of a tax system, you say, OK, but should we give that taxpayer that tax benefit.

Mr. ENSIGN. Mr. Entin.

Mr. ENTIN. Lenders aren't completely unaware of the possibility that inflation might be higher in a few years than it is today, and that is factored into long-term interest rates. The lender and the borrower have already taken care of that problem between themselves. There is no need to worry about it in terms of tax policy.

Mr. ENSIGN. OK. Mr. Usher, we have heard a lot about manufacturing jobs leaving our country, and it would seem to me that one of the ways that we can partially correct that is by correcting the AMT. It would seem very difficult to me to argue against enacting some of the policies that we are talking about here in the Contract based on those.

Your comments?

Mr. USHER. I appreciate that, and I agree. As I said before, the manufacturing base in this country is important, we need to protect it, and this would help.

Mr. ENSIGN. OK. Thank you, Mr. Chairman.

Mr. BUNNING. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

This morning I heard the ranking minority member say that Republicans don't borrow money. Well, I would like to remind the Republicans in this room and my Democratic friends who may be unaware, but Republicans borrow money to purchase homes, Republicans borrow money to start a business, and unfortunately Republicans also run up their credit card debt. I would also remind him that it was the $15,000 to $30,000 wage earners who crossed the line in droves this year to vote Republican because they were sick and tired of the taxation, regulation and the government bureaucracy that has continued to be piled upon them over the last 40 years. I guess I just get tired of the class warfare.

On this panel I consider the experts to be Mr. Sigler and Mr. Usher because they are out there in the real world. And I like the fact that Mr. Christian here has got his head conservatively screwed on straight and Mr. Entin also knows what he is talking about and Mr. Jorgenson, I didn't get your testimony, but I think you are also in there. Mr. Entin, yesterday Dr. Jane Gravelle from the CRS who is supposed to be working for the taxpayers came and talked about why a capital gains tax cut was such a bad deal for Americans. The day before that another academician spoke about why it was bad for America and 2 weeks ago Les Samuels talked about why it was bad for America.

Why is it that the people who are teaching the future leaders of this country don't understand what makes this country work? How can we reeducate the educators? Where are they getting offtrack? Is it government bureaucracy? Is it the fact that Miss Gravelle spent 25 years of her life in government service? Mr. Schapiro, have you ever run a company?

Mr. SCHAPIRO. I didn't run a company, but I have run some business ventures and real estate, yes.

Mr. CHRISTENSEN. You have never owned and operated a company, though, have you?

Mr. SCHAPIRO. I have never owned and run a company, no, sir.

Mr. CHRISTENSEN. Mr. Entin, can you help me on this? I am frustrated. I was sent here by the taxpayers to try to change this place and I run against the Harvard and Yale types and they all think they have the answers and they don't.

Mr. ENTIN. There is a draft tax primer out of the University of Cincinnati business school I worked on a couple years ago which goes to some of the history of some of the notions that were built into the current income tax and some of the professors who started all this.

If I send that to you you might be able to see where the teachers of the current teachers came from and why they did these things. I think we are all imprisoned by what we learn in our first undergraduate course in economics, we forget to question our professors a little bit.

Some of the things that went on back then will probably give you an idea where all this came from, and it might startle you quite a bit because a lot of it was nonsense. I will send that over to you.

Mr. JORGENSON. Mr. Christensen, I would like to respond to your question. I am the only academic on this panel. Not only that, I teach at Harvard. I was a student at Harvard many years ago.

I think what you will find is that there has been a sea change in opinion among academics and especially among people that are going to testify before this committee. The kind of ideas that Mr. Christian has put before this committee, which are built around the idea of a fundamental shift away from taxation based on income toward taxation based on consumption is about as close to an academic consensus as anything I have ever seen in my relatively lengthy career.

That is not something that is specific to Harvard or Cincinnati or Yale or any other institution that you want to name. I think that the kind of ideas that are represented in the Contract, especially the idea of neutral cost recovery, are essentially ideas whose time has come, and that is just as true of academic life as it is of the business life.

Mr. CHRISTENSEN. Well, there is hope for Harvard, then.

Mr. Chairman, I appreciate your indulgence. I have been thinking about this for the last 4 hours, so I wanted to say thank you.

Mr. BUNNING. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman.

I am tempted to carry on the discussion about the Devil under the bed. I just think there are legitimate differences of opinion, there always have been, there always will be, and I am not sure we ought to look for demons. I went to the University of Chicago, which was one of the institutions which fostered conservative economics in this country.

So why don't we get back to talking about ideas, and I am sorry I wasn't here for all of the discussion, but I guess the last exchange included some comment on Mr. Schapiro's chart and its indication that there could essentially be overcompensation. And I think the response was that when the original deal was made that was taken into account. Is that what you are saying, Mr. Entin?

If you go back to the table and it shows Mr. Schapiro's testimony, some rather startling figures, I think, which indicate that the way to handle this problem—and I am in favor of trying to stimulate growth in this country and access to capital—that this may be too coarse a way to do it, and it will have much too uneven an impact, and it will have some consequences that really aren't predictable and aren't really healthy.

I think, Mr. Schapiro, that is really what you are saying, so let's have a serious discussion for a minute or two about the figures in his chart.

Mr. ENTIN. The discussion I had a moment ago, however, was about the concept of indexing interest, which was a different question. The figures in the charts only represent in present value 100 cents on the dollar.

Looked at another way, the apparent excess above 100 cents on the dollar in nominal terms that you see in those charts merely represents the value by which current depreciation schedules underdepreciate or gyp the taxpayer. If you deflate all of those numbers to year one dollars, you get 100 cents on the dollar. There is no excess there at all.

I disagree with the notion that having a large writeoff in year 23, for example, for the slice of equipment that is supposedly wearing out in year 23 is going to lead people to lock in the investment. This is only compensation for what they were being deprived of by time and inflation over the period to that date.

Improving the writeoff by that amount in that year is appropriate. It will give them the money to go out and replace what has actually worn out. A new piece of property similar to the one they have been depreciating, which is on the market today, will have gone up with inflation over that period, and they will need the extra money to be able to turn around and replace what they are using up.

In addition, the NCRS adjustment does not merely apply to the property that you already have. It will also apply to property that you might be about to buy. Not only is your current property enhanced in value in your eyes, but so is the property you might turn around and buy if you sold the old property.

Mr. LEVIN. Maybe.

Mr. ENTIN. So I do not think this would have a serious impact in locking things in.

Mr. LEVIN. Mr. Schapiro.

Mr. SCHAPIRO. My only point is you wouldn't sell the old one. That is the whole point because it is there, and if it is sold you lose the benefits, and you have to keep it in order to get these ongoing benefits. That is the only point that is being made.

On the indexing point, it is really not indexing interest. It is indexing principal. Where you do not have an inflation risk on the principal element, does the tax system wish to provide a benefit reflecting inflation on one side when you are not at risk in the other?

That is purely a policy question. That is a question for this committee and for Congress.

It is not economics or anything. It is a question of how this committee and Congress wants to run the tax system. You are talking about elements of fairness, and you can decide it either way. But on the point of keeping old property, you only get the benefit each year you keep it. As soon as you sell it, it is gone; or if you abandon it, it is gone; and you don't keep getting that ongoing benefit.

I am not suggesting that perhaps it isn't appropriate to give a benefit in present value equal to the NCRS benefit up front. I mean, if someone said, "Is there any tax policy against immediate expensing," I would say as a tax technician, "No, that isn't a tax policy question." You can have a sound tax system and do that. It might cost a lot of money. If someone asks is there a tax policy against changing the AMT as a matter of sound tax administration, the answer is that there is no such tax policy against it. That is an economic question. I am arguing only that the NCR system runs into some odd, unexpected, unusual and maybe undesirable technical tax aspects.

Mr. LEVIN. Thank you.

Mr. BUNNING. The gentleman's time has expired.

Let me give a—we are in a 15-minute quorum call vote right now. Mrs. Johnson will end the questioning, and we will dismiss the panel, and the third panel will come forward when we get back. So Mrs. Johnson may inquire.

Mrs. JOHNSON. Thank you, Mr. Chairman, and I thank the panel.

I have enjoyed the discussion very much and I regret that I wasn't able to be here for your testimony, but I will review it because I am particularly interested in this aspect of the proposals before us. That is, the issue of adoption of neutral cost recovery as opposed to increasing expensing, and many of the points that you made are of great interest to me.

It does concern me that in adopting neutral cost recovery we should go to a richer, in a sense, reward for a certain kind of investment in our society when as important to growth as capital equipment is, training is equally important, service industries are an important gross sector and don't benefit from these tax expenditures by the government to nearly the degree that manufacturing does, and according to some of my manufacturers we actually have a plethora of equipment right now, having increased productivity dramatically in the last 10 years.

It also concerns me that we go to neutral cost recovery with all of its costs at a time when obsolescence is driving the useful life of equipment rather than wear and tear.

With those kinds of concerns in mind, it seems to me that at least what I take from this hearing is that fixing the AMT problems are terribly important and the combination of AMT reform and enriching expensing to maybe $50,000 or $100,000 which are ideas that came out of earlier hearings might be a combination of policies that would have far greater impact on economic growth than adopting neutral cost recovery. I open that to comment.

Mr. Sigler, welcome, it is a pleasure to have you. You have been very helpful to me in other instances.

Mr. SIGLER. Thank you.

I think one of the things you have to be careful of is what business you are talking to. You are talking to two people here who represent companies that have been hard hit by AMT. I think the point has been made here that it is different for others, but for us AMT is all encompassing and we have to make our investment decisions based on its effect.

I would say in response to the comments you made in your remarks, that we spend large amounts of money on training and employee development every year, and we expense them all. We get an immediate tax benefit for them, but when we spend $1 billion to build a pulp and papermill we can't recover those costs for 13 or more years. We are spending anywhere from $30 to $50 million in a mill for training each year because if you think about it, everybody changes jobs. We expense the $50 million, and that $50 million is back to use again or the tax effect of it, but that is not the case with investment in equipment. Investment in equipment—whatever equipment it is, whether it is a truck, or a paper machine—it gets handled in a more detrimental way for the company.

But expensing for all investment—whether it's equipment or training—is what we really would like.

Mrs. JOHNSON. The ideal is total expensing of equipment. I appreciate that.

Mr. USHER. We spent an awful lot of money on training. In fact, at our latest mill that we have brought on, we averaged about $55,000 per employee in training costs. We found that to be a great investment.

I don't want you to get the impression that I am running down service-type jobs. I am not. We use many service-type jobs but, in the final analysis, to maintain and increase the wealth of the country, you have to make things. You have to grow things, and you have to build things. That is how wealth is created, and it is the manufacturing sector that creates a great deal of this wealth.

Mrs. JOHNSON. I do appreciate that. I had some conversations recently that have focused on what it takes to create wealth in the service industry, and capital investment plays a smaller role in that. But there are some other things we could be doing in the Tax Code that would enable service industries to grow more rapidly.

So in looking at how much, in a sense, of the taxpayers' dollars we spend on capital equipment, I think we have to weigh that, but I do appreciate that.

I appreciate the panel's input on these issues. Thank you.

Mr. BUNNING. Thank you, panel, for being here, and we will recess until we finish our vote. We have 5 minutes. Thanks.

[Recess].

Ms. DUNN [presiding]. The committee will reconvene its hearings.

Our third panel today is composed of Cornelius Powell, chairman of Capital Formation Task Group, Chemical Manufacturers Association, and vice president of taxes, Air Products & Chemicals, Inc., from Allentown, Pa.; Victor Beghini, president, Marathon Oil Co. from Houston, Tex., who will be speaking to us today on behalf of the American Petroleum Institute; John D. McCallum, vice president of corporate tax, Potomac Electric Power Co. on behalf of the Edison Electric Institute; John Huber, government affairs counsel, Petroleum Marketers Association of America; and Martin Sullivan, adjunct scholar from AEI.

And I would like to start the testimony with Mr. Powell.

STATEMENT OF CORNELIUS P. POWELL, CHAIRMAN, CAPITAL FORMATION TASK GROUP, CHEMICAL MANUFACTURERS ASSOCIATION, AND VICE PRESIDENT, TAXES, AIR PRODUCTS & CHEMICALS, INC., ALLENTOWN, PA.

Mr. POWELL. Thank you, Madam Chairwoman.

Philosophically, the neutral cost recovery system would be a welcome addition to the Internal Revenue Code. Its inclusion in the Contract With America was an acknowledgment of the need to move toward current expensing of capital expenditure for plant and equipment. It was also an indication of a commitment to achieve a competitive cost recovery system in the United States.

Despite a philosophical agreement, CMA does not believe the backloaded tax depreciation system embodied in NCRS is desirable, that is, we do not believe it is desirable. We have four main reasons.

First, front-end cash which would otherwise be available for new investment would be reduced under NCRS. In the chemical industry it would take until the end of the fourth year after a plant startup before the cash generated under the new system would equal that generated under the present system.

Second, the maximum eventual potential benefit to the chemical industry is not substantial before considering risks in the new system. Using typical analytical tools and assuming the 3 percent rate of inflation, the maximum present value of tax deductions under the proposed system over the current system for the chemical industry works out to only about 2.75 percent of original cost.

Third, concern exists among some member companies as to whether the intended benefit from the deferred and indexed depreciation would be fully achieved. This concern stems from the alternative minimum tax and concern as to possible future legislation.

Fourth, NCRS would inject a level of uncertainty into projecting future Federal tax revenue. For example, it is estimated that at a 3 percent inflation rate, the reduction in future tax revenue for an asset with a 20-year life would be 11.6 percent of original cost. The reduction in tax revenue would rise to 28.5 percent if the inflation went from 3 to 6 percent.

Now, the fact that the proposed neutral cost recovery system would be elective as proposed does not answer these concerns. In fact, one concern is whether as enacted it would remain elective.

Past that, if there is an election, taxpayers would tend to elect out of NCRS if they had an AMT problem or if they anticipated because of the cyclical nature of their business they would be moving into AMT. That would in effect stretch out the cash flow benefit, the timing of its realization.

In answer to the fundamental question the Speaker presented in his recent testimony, CMA does not believe NCRS would provide the additional incentive to create even 1,000 new jobs in the 1.1 million chemical industry employment.

It is suggested that as a first step in U.S. cost recovery reform you give consideration to eliminating or substantially modifying the alternative minimum tax. The AMT is bad policy, penalizes those that invest the most in new equipment and increases the current tax effective rate when earnings are down.

You cannot make a meaningful change in our tax recovery system without first fixing the minimum tax problem. We have listed suggested reforms in our written statement to the AMT.

Thank you for your attention.

[The prepared statement follows:]

STATEMENT OF
CORNELIUS P. POWELL
VICE PRESIDENT-TAXES
AIR PRODUCTS & CHEMICALS, INC.
ON NEUTRAL COST RECOVERY PROVISIONS
OF THE "CONTRACT WITH AMERICA"
ON BEHALF OF
CHEMICAL MANUFACTURERS ASSOCIATION

JANUARY 26, 1995

The Chemical Manufacturers Association (CMA) welcomes this opportunity to submit the views of the U.S. chemical industry on the provisions for an improved and more neutral cost recovery system expressed in the "Contract with America" and reflected in H.R. 9.

CMA is a nonprofit trade association whose 188 member companies represent more than 90 percent of America's productive capacity for basic industrial chemicals. Since 1991 the chemical industry has been the nation's leading exporter with an estimated $50 billion in 1994 exports. These exports help insure 1.1 million high wage, chemical industry jobs throughout the U.S.

SUMMARY

Although CMA supports the general philosophy of improved and more neutral cost recovery expressed in the Contract, we are very concerned that, as initially proposed, any revenue costs of an elective neutral cost recovery system (NCRS) would be principally financed by reducing 200 percent declining balance depreciation to 150 percent. From our industry's perspective, the potential increase in depreciation benefits under NCRS does not warrant the attendant risk and added complexity.

QUESTION PRESENTED BY THE SPEAKER

In answer to the fundamental question the Speaker presented in his recent testimony before this committee, we do not believe NCRS would provide the additional incentive needed to create 1,000 new jobs in the chemical industry. In the early years after enactment, NCRS could lead to a reduction in jobs. Thereafter, the impact of NCRS on job levels would depend on whether industry perceives that Congress will modify NCRS if it loses revenue. We believe that modification or termination of the alternative minimum tax (AMT) would likely produce more jobs than would the NCRS proposal.

CMA SUPPORTS THE GENERAL PHILOSOPHY OF NCRS

As indicated, CMA supports the general philosophy embodied in the NCRS proposal. A commitment to move toward the economic equivalent of current expensing is welcomed. It evidences the acceptance of the need for the U.S. to maintain a competitive cost recovery system. Despite our philosophical agreement, CMA does not believe that a move to the back-loaded tax depreciation system embodied in the NCRS is desirable. To focus on our very specific concerns, we list them below in as direct and forthright manner as possible:

- o We find it undesirable to trade a part of the front-end cash tax recovery under the present system for the hope of improved future recovery.

- o Applying a typical 11% cost of capital discount rate employed in analyzing new manufacturing projects and assuming a continuing inflation rate of 3%, the maximum benefit of the proposed system to the chemical industry is only about 2.75% of the original cost of the asset involved.

- o This modest potential benefit from NCRS is not likely to stimulate new investment even if the perceived detriments and risks of the system are ignored.

- o One perceived detriment is that under NCRS, tax cash recovery would be delayed. For chemical companies, the catch up point would not be until the end of the fourth year after plant startup.

- Many companies are not short on investment opportunities. They are short on cash. It simply is not prudent for them to borrow additional cash to undertake new projects. If they adopt NCRS, these companies would have to cut back on capital investment that otherwise could have been financed by cash generated by tax depreciation deductions under the present law.

- One risk our members see is the uncertainty as to their capacity to utilize the deferred and increased depreciation contemplated under NCRS because:

  - They have concern as to whether, once enacted, NCRS would be modified as the deferred deductions begin to reduce tax revenues.

  - A future economic turndown could reduce the taxpayers capacity to use the write-off as it becomes available. The taxpayer may have insufficient profits and, as a result, fall into a tax loss or minimum tax paying position.

  - A substantial turndown in the company's profit could occur.

- Many chemical companies enter into long-term fixed-price requirement contracts and build new plants from which to supply the required product. Typically, these contracts would not provide for a price adjustment to reflect changes in the income tax law. NCRS would introduce a higher element of uncertainty in the negotiation of these fixed-price contracts in the sense that the further out the expected tax recovery, the greater the risk.

- Collateral impacts under other provisions of the code would have the effect of reducing the NCRS benefit by a modest amount. These areas include:

  - The depreciation in excess of plant cost would reduce the tax benefit available under the Foreign Sales Corporation export incentive.

  - The uniform capitalization rules would have the effect of removing depreciation capitalized as part of the cost of inventory from further indexing.

  - The present value tax benefit on a failed project would be less than under the current system.

  - Because the applicable GDP deflator would have to be estimated, some taxpayers would find it necessary to make conservative estimated tax payments in order to avoid the risk of penalty for underpayment.

- Various proposals to substantially restructure the federal tax system are now being given serious consideration. Adopting NCRS would tend to impede reform for a restructured system by virtue of the tax deductions deferred until later. Consequently, a greater revenue loss could then be involved in the transition to the new system. The taxpayer whose depreciation deductions were deferred under NCRS could receive lower tax benefits because of lower tax rates under the restructured system.

- Many capital intensive companies are now paying position or are working off AMT credits generated in prior years. Until these companies are entirely out of the minimum tax system, the present value benefit from additional depreciation under the neutral system will not be at the full 35% corporate rate. The present value benefit will be somewhere between 20% and approaching 35% depending on how long after the depreciation otherwise became available the taxpayer works out of its AMT position.

ELECTING OUT OF NCRS

It is recognized that as proposed, the taxpayer could elect out of the neutral cost recovery system. Assuming the election is retained, in any election of NCRS, our concern is that:

- Taxpayers who foresee difficulty in using NCRS effectively will not elect the system. This could include those working out of AMT and those concerned about future legislation designed to reduce the presently anticipated benefit of NCRS. Thus, the presently anticipated front-end revenue might not be there to finance the proposed change in law.

- Under NCRS, depreciation in excess of cost will be generated. This will result in increased financial earnings. Assuming an election is available under NCRS, a taxpayer concerned with the stock market reaction to a competitor's reported earnings from participation in NCRS might feel constrained to adopt the NCRS system even though it would otherwise not find it desirable from the taxpayer's cash standpoint to defer tax depreciation.

REVENUE IMPACT

Because NCRS is tied in part to the rate of inflation, we believe it will be difficult to predict the future tax revenues generated under the system. As we have stated, NCRS would provide little incentive for new investment and jobs in the chemical industry and, therefore, may not generate additional taxable profits.

Our test of the impact of inflation indicates that the eventual tax revenue reduction on a 20 year MACRS asset at 3% per year inflation rate would be 11.6% of the original cost of the asset. At a 6% inflation rate, the loss in revenue would rise to 28.5% of the cost of the asset. Admittedly, these projections oversimplify the problem. Certainly, additional tax revenue would be generated by virtue of the higher inflation, but there is a heightened risk of revenue uncertainty when the amount of the future deduction under NCRS is tied to inflation.

Attachment A sets forth our estimate of the reduction in tax revenue attributable to assets in various groups at different levels of inflation.

AMT REFORM AS AN ALTERNATIVE

While the present capital cost recovery system can be improved, capital intensive manufacturing industries, including the chemical industry, would benefit directly from your effort to repeal or to lessen the burden of the AMT. Because these reforms would increase front-end cash flow available for investment in equipment and jobs even when earnings are low, they are likely to have more significant impact on employment levels in manufacturing than would NCRS.

Most importantly, neither improved capital cost recovery nor reform of AMT (which itself is largely a penalty on depreciation), should be financed by reducing 200% declining balance depreciation to 150%.

Many chemical companies are not currently paying the AMT because of the strong current domestic sales and export demand for their products. Yet, the pernicious effect of the AMT on our operations remains. The chemical industry is highly capital intensive and fixed costs, principally depreciation on equipment, remains high even when income declines. In addition, the industry must also continue to make new capital expenditures to meet Congressionally mandated environmental standards regardless of current economic conditions. Should our sales and exports decline because of a downturn in the domestic economy or increased worldwide competition, many chemical companies could again be paying the AMT when their cash needs are greatest. In the recent recession, this problem was replicated across American industry and may even have extended the duration of that recession.

Without fundamental structural change in AMT, its principal effect will be to continue to punish America's basic heavy industries during periods of economic slowdown. These industries will find it increasingly more difficult to compete internationally during these periods. There are serious public misconceptions about why and under what circumstances corporate taxpayers pay the AMT. Most misunderstood is the effect of the AMT in an economic downturn or recession. One principal consequence of this tax is that American manufacturers that regularly pay Federal income taxes will have to pay the AMT precisely when their cash needs to finance new investment and jobs are greatest.

POSSIBLE AMT CHANGES

We are appreciative of the work of this Committee in its efforts in 1993 to alleviate these problems, but much still remains to be done. Alternatives include:

- The AMT penalty on depreciation would be reduced significantly by having AMT depreciation periods match those provided for regular income tax purposes.

- Accelerated depreciation on capital expenditures to meet Congressionally mandated and voluntary environmental standards should not be subject to the AMT.

- Congress should also reconsider the limitation imposed on the use of accumulated AMT and other tax credits against AMT liability.

We again commend the framers of the "Contract with America" for having included provisions for improved capital cost recovery and AMT reform. The vital spirit of that contract is to achieve effective, responsible progress toward these goals for America.

The Federal budget imposes limits on how much reform this committee can undertake. Progress toward real AMT reform, however limited, is the most important progress toward a rational capital cost recovery system that Congress can make at this time. We look forward to working with you on this all-important subject.

Attachment A

NCRS

ESTIMATED FEDERAL REVENUE REDUCTION

AS A PERCENT OF PLANT COST*

MACRS Write Off Period	Inflation Rate	
	3%	6%
5 year	5.5%	8.3%
7 year	8.2%	12.7%
10 year	12.6%	20.4%
15 year	8.2%	19.0%
20 year	11.6%	28.5%

* Represents future reduction in revenue without discount to reflect time value.

Ms. DUNN. Thank you very much, Mr. Powell.
We will continue with Mr. Beghini.

STATEMENT OF VICTOR G. BEGHINI, PRESIDENT, MARATHON OIL CO., ON BEHALF OF THE AMERICAN PETROLEUM INSTITUTE

Mr. BEGHINI. Thank you, Madam Chairwoman.

My name is Victor Beghini. I am president of Marathon Oil Co. I am testifying on behalf of the American Petroleum Institute.

API represents approximately 300 companies engaged in every aspect of the oil and gas industry. I am pleased to appear today to discuss the proposed neutral cost recovery system.

The stated goal of NCRS is to reduce the cost of capital in order to make American industries more competitive, stimulate additional investment, and create new jobs. API members heartily endorse that goal.

The oil and gas industry is a vital part of the Nation's economy and is also one of the country's most capital-intensive industries. We are therefore vitally concerned with the effect of cost of capital on our ability to find, develop, and deliver new energy resources.

In our exploration and production operations, because many promising sources of new reserves are located offshore in deep water or in operationally difficult frontier areas, huge capital investments and very long lead times are required.

Typically an oil and gas project in these areas can take over 7 years to reach the producing stage. It is only then that we can begin to recover our capitalized cost. Onshore lower 48 reserves require increasingly sophisticated drilling and recovery techniques which are also high cost. In the refining and marketing segment of our business, we are faced with enormous costs imposed by government environmental regulations.

These are unfunded mandates which are intended to be of a general societal benefit, but they also reduce a company's income and return on investment. Obviously our industry has a very strong interest in proposals that would reduce the cost of capital. As the Tax Reform Act of 1986 amply demonstrated, tax policy does have a significant impact on the cost of capital.

While TRA did provide a rate reduction for all taxpayers, it did so at the expense of capital-intensive industries such as ours by extending depreciation periods, repealing the investment tax credit, and adding the alternative minimum tax under which taxpayers face not only tax acceleration but possibly even double taxation because of the limitation on the use of foreign tax credits.

While NCRS represents some improvement in the treatment of depreciable capital expenditures, there are concerns about its design and coverage, and it should not be viewed as a substitute for a fundamental reform of the AMT.

First, over the long term, there is a cumulative benefit when you analyze the effect of NCRS on a typical investment profile for the oil and gas industry, but as the earlier panel testified, some taxpayers would actually pay more taxes in the early years of NCRS. The Treasury revenue estimate of $18.4 billion for the first 5 years confirms this fact. This cash flow drain will likely have a negative effect on the economy.

Second, while application of NCRS to alternative minimum tax depreciation provides some relief for AMT taxpayers, far more fundamental reform is needed if we are to remove the current disincentive for capital investment. For oil and gas companies, many of whom are subject to the AMT, the minimum tax has the perverse effect of penalizing them when prices decline and when investment in property, plant, and equipment increases.

Furthermore, while Congress intended the AMT as a temporary prepayment of tax, it actually represents a permanent tax increase for some oil and gas companies. Once a capital-intensive company gets into the AMT position, it is exceedingly difficult to get out. NCRS does not address these fundamental AMT flaws.

Finally, I must note that under the NCRS proposal, the oil and gas industry's depletable assets would not be provided indexing of cost recovery deductions. The segment of the oil and gas industry represented by integrated oil companies is the only segment of U.S. capital-intensive industries that currently does not have accelerated cost recovery for a substantial portion of its capital investment.

The exclusion of depletable assets from NCRS only exacerbates that disparity because such assets would also be denied the benefits of NCRS indexing. Cost depletion deductions should be included in any neutral cost recovery system.

In summary, Madam Chairwoman, we support your efforts to improve capital cost recovery. To encourage more investment in the oil and gas industry and to eliminate the disparate treatments of depletable assets, the NCRS concept should be applied to cost depletion.

Let me close by again emphasizing fundamental reform of the AMT must be an integral part of any proposed goal to improve capital recovery and enhance economic growth in this industry.

Thank you.

[The prepared statement and attachments follow:]

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WRITTEN STATEMENT TO ACCOMPANY
TESTIMONY OF
VICTOR G. BEGHINI, PRESIDENT
MARATHON OIL COMPANY

ON BEHALF OF THE AMERICAN PETROLEUM INSTITUTE

REGARDING THE PROPOSED NEUTRAL COST RECOVERY SYSTEM
TITLE II OF H.R. 9, THE JOB CREATION AND WAGE ENHANCEMENT ACT

Committee on Ways and Means
U.S. House of Representatives
January 26, 1995

This statement is submitted by the American Petroleum Institute (API) for the record of the January 26 hearing of the House Ways and Means Committee on the proposed Neutral Cost Recovery System (NCRS), Title II of H.R. 9, the Job Creation and Wage Enhancement Act. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing.

The goal of the NCRS proposal is to reduce the cost of capital by increasing depreciation deductions to achieve the economic equivalent of expensing. API heartily endorses the overall goal of improving capital cost recovery, and we commend the Committee for moving expeditiously to address this important concern.

Proposals to modify the current system of capital cost recovery are of particular importance to API's member companies because of the capital intensive nature of oil and gas operations. The capital intensiveness of an industry may be defined as the ratio of its percentage share of the national capital stock relative to its percentage contribution to national income. When this measure is used, as Table 1 indicates, the petroleum industry can be seen as one of the nation's most capital intensive industries, when compared to other major manufacturing and service industries. Of the sectors surveyed, only electrical utilities are more capital intensive. If one simply uses an industry's percentage share of net property, plant and equipment as the measure of capital intensiveness, oil and gas production and refining are still seen to be capital intensive relative to other major manufacturing and selected service industries. Only the communication industry and electric services have larger shares.

Because the industry is so capital intensive, API members are vitally concerned with the effect of the cost of capital on their ability to find new energy resources, and develop and deliver them to the American consumer at a reasonable price. In exploration and production operations, because many promising sources of new reserves are located offshore in deep water or in operationally difficult frontier areas, huge capital investments and very long lead times are required. Typically, an oil or gas project in these areas can take over 7 years to reach the producing stage. It is only then that a company can begin to recover its capitalized costs. Onshore lower 48 reserves require increasingly sophisticated drilling and recovery techniques which are also high cost. In 1991--the latest year for which complete industry data are available--the petroleum industry invested $22 billion in exploring for and developing oil and gas reserves.

In the refining and marketing segment of the business, the industry is faced with enormous costs imposed by government environmental regulations. For example, the National Petroleum Council estimates that over the period 1991-2000, refiners will be required to expend $37 billion to comply with environmental mandates. These are unfunded mandates which are intended to be of general societal benefit. But, they also reduce a company's ability to add to the manufacturing capacity of the industry and decrease a company's income and its rate of return on investment.

Neutral Cost Recovery System

Investment in new plant and equipment is quite sensitive to capital cost recovery rates. In 1981, the capital cost recovery system relevant to most investment in the United States was improved, moving toward the goals of full recovery, simplicity and economic efficiency. Succeeding tax Acts culminating with The Tax Reform Act of 1986 reversed this favorable development. While TRA '86 did provide a rate reduction for all taxpayers, it did so at the expense of capital intensive industries such as the petroleum industry by extending depreciation periods, repealing the investment tax credit, imposing complex production period capitalization requirements, and adding the Alternative Minimum Tax under which taxpayers face not only tax acceleration but possibly even double taxation because of the limitation on the use of foreign tax credits. NCRS would partially redress the capital cost recovery dilution, and in that regard would be an improvement over current law.

Under current law, depreciable costs are recovered over a statutory asset life dependent on the use of the asset. Even in the absence of inflation, this extended recovery period results in a loss of the present value of the recovery of capital costs. Secondly, inflation during the recovery period adds an additional loss by driving up the replacement cost of the asset. As a result of both factors, current law may cause a loss of over half of real asset value over time, depending on asset life, inflation, and discount rates, as seen in Table 2.

The proposed neutral cost recovery system attempts to eliminate the disincentive to investment created by the current system. However, rather than simply allow for full expensing of the capital, it provides for a system of indexation for both inflation and deferral value which exacerbates the recovery problem early in the asset life (by substituting double declining balance depreciation schedules with 150% declining balance schedules for many asset classes) in return for increased nominal recovery later in the asset life.

One concern with NCRS is this move from 200% to 150% declining balance depreciation for some assets. It is clear that over the long term there is a cumulative benefit when one analyzes the effect of NCRS on a typical investment profile for the petroleum industry. But, because of the move from 200% to 150%, some petroleum companies and companies in other industries would actually pay more taxes in the early years of NCRS. The Treasury estimate of an $18.4 billion revenue increase for the first five years confirms this fact. This cash flow drain will likely have a negative effect on the economy. Thus, it would seem to frustrate the overall goal of the proposal: to stimulate economic activity and create new jobs by increasing taxpayer cash flow.

Furthermore, since the benefits of NCRS are significantly "back-loaded" with cash tax savings available for some assets only five to seven years after enactment, taxpayers will not realize the benefits unless full implementation of the proposal is assured.

An additional concern with regard to the design of the proposal has to do with complexity. API's members, as other corporate taxpayers, face large compliance costs because of complexity of the tax law. One goal of any tax legislation should be to reduce that burden. NCRS, as proposed, requires a quarterly inflation adjustment calculation. Making the adjustment annually rather than quarterly would be an improvement.

Cost Depletion

The segment of the oil industry represented by integrated oil companies is the only segment of U.S. capital intensive industries that currently does not have any accelerated cost recovery for a sizeable portion of its capital investment -- that portion that is subject to cost depletion. Using API and Department of Energy data for 1991, the latest year for which complete information is available, API estimates that of $4.0 billion invested in capitalizable exploration and development costs, over one-fourth ($1.2 billion) must be recovered through this method.

Typically, the largest of the depletable costs is the cost of acquisition of the right to extract oil or gas. This is treated as a capital cost for both financial and tax purposes. Another significant portion of capitalized costs of an oil or gas property (for tax purposes) consists of geological and geophysical exploration costs. For successful projects these costs may be expensed for financial accounting purposes while they must be capitalized for tax purposes. Cost depletion is typically taken by the unit-of-production method -- which limits current capital cost recovery to an estimate of how much of the property's total remaining output is represented by current production. Thus, when a barrel of oil is produced, it is ratioed with remaining reserves and multiplied by the adjusted tax basis of the property involved to determine the amount of the current depletion deduction. For a long-lived property, this method of recoupment is one of the slowest methods of capital recovery available under current law. Even very modest rates of inflation will very rapidly erode the real value of cost recovery deductions under the unit of production method. Real costs of capital invested are thus "underrecovered" primarily due to the effects of inflation. These costs should be included in any "neutral" cost recovery system.

Geological and Geophysical Costs (G&G)

Geological and geophysical costs (G&G) are costs associated with surveying and evaluating a potential oil and gas property. Geological studies and geophysical surveys are the initial steps in evaluating an oil and gas prospect. The costs of core drilling, seismic studies and other G&G activity are incurred for the purpose of ascertaining the existence, location, extent and quality of any deposit of oil or gas.

Technological change in the petroleum industry is increasingly being recognized as one of the most significant determinants of future domestic oil and gas supply prospects. Recent studies completed by the Department of Energy, the National Petroleum Council, the Gas Research Institute, and API, as well as a number of recent academic studies, have all documented the major influence of technological change on stabilizing or reversing the decline in domestic supplies of oil and gas. For example, DOE estimates that sustained modest increases in drilling productivity could increase the level of ultimately recoverable oil resources by nearly 40% within the next 15 years.

While a number of innovations have contributed to recent and expected increases in drilling productivity, G&G expenditures have played a major role, and are expected to play even a more significant role in the future. In Salomon Brothers annual survey of oil and gas industry spending plans, respondents for the last three consecutive years have identified seismic technology as the innovation with the greatest impact on upstream spending decisions. For 1995, 75% of respondents identified seismic technology (G&G) as the most influential technological innovation affecting such choices.

While there still is no technology that permits us to reliably identify the location of oil and gas without drilling, recent improvements in seismic technology have provided a rapidly improving capability to visualize complicated geological structures. This provides more information than previously available to target drilling activity. The additional information can sometimes make it economic to seek out and successfully develop far smaller reservoirs than would have even been considered a decade ago. Such technology has effectively enabled the industry to substitute G&G for some drilling activity.

Ironically, however, current tax treatment inhibits the development and application of such substitution. Under current treatment, a taxpayer typically cannot recover much more than half of the present value of the cost of successful G&G efforts over the course of a 20 year field life with cost depletion. Furthermore, the administrative costs of determining and tracking G&G expenditures are burdensome to both the industry and the IRS. The current tax treatment penalizes the utilization of these critical new technologies.

Under today's conditions, oil and gas exploration is being carried out in increasingly hostile environments and at increasingly higher costs. Geological and geophysical costs are an important and integral part of the exploration process on a daily basis and, as such, should be treated as ordinary and necessary business expenses. Spreading their recovery over the life of the field results in little or no benefit on a present value basis because of the long lead times which characterize oil and gas development. They should be allowed as a current deduction.

Alternative Minimum Tax

While application of NCRS to Alternative Minimum Tax depreciation provides some relief for AMT taxpayers, far more fundamental reform is needed if we are to remove the current disincentive for capital investment. At the minimum, the NCRS should not be biased against AMT taxpayers. For petroleum companies--the vast majority of whom are subject to the AMT--the minimum tax has the perverse effect of penalizing them when prices decline and when investment in property, plant and equipment increases. Furthermore, while Congress intended the AMT as a temporary prepayment of tax, it actually represents a permanent tax increase for some petroleum companies because once a company gets into an AMT position it is very difficult to get out because continuing or expanding investment in depreciable property triggers additional AMT penalty. NCRS does not address these fundamental AMT flaws.

The effect of the AMT is to drive up the after tax cost of capital and to depress new investment in plant, property and equipment. A 1991 study by the American Council for Capital Formation found that the cost of capital for AMT companies making new investments was increased by a range of 10 to 22 percent over the cost of capital under the regular Modified Accelerated Cost Recovery System.

This increased cost of capital and reduced cash flow significantly depresses the level of new investment necessary to remain competitive. Typically it is these capital intensive industries that provide a large fraction of the high paying jobs in the economy. The longer lived manufacturing assets such as those used in automobile manufacturing, chemicals, oil and gas production and refining, pulp and paper, and steel are subject to the greatest increase in the cost of capital as a result of the AMT.

While twin objectives of the Tax Reform Act of 1986 were tax simplification and compliance cost reduction, neither objective was accomplished. A 1993 Tax Foundation study entitled "The Income Tax Compliance Cost of Big Business" reports that "there is near unanimity among senior corporate tax officers that TRA 1986 added complexity to the tax system, resulting in a combination of higher compliance costs and less accurate information transmission [to the IRS]." The Alternative Minimum Tax was the item most often mentioned as contributing to that complexity.

Conclusion

To summarize, the goal of NCRS to improve capital cost recovery is laudable and API commends the Committee for moving to address the issue. Capital intensive industries, such as the petroleum industry, were hurt by the Tax Reform Act of 1986 and NCRS would partly redress that problem. However, it does not go far enough to alleviate the effect of the Alternative Minimum Tax. Finally, the petroleum industry has a portion of its capitalized costs subjected to an extremely slow form of recovery--cost depletion. These costs should be included in any "neutral" cost recovery system.

TABLE 1: "CAPITAL INTENSITY BY INDUSTRY"

(Corporate Net PPE/Total U.S. Corporate Net PPE x 100)

	DEPRECIABLES (%)	DEPLETABLES (%)	LAND (%)	PERCENT OF TOTAL U.S. CORPORATE NET PPE	CONTRIBUTION TO NATIONAL INCOME (%)	CAPITAL INTENSITY
	(1)	(2)	(3)	(4)	(5)	(4)/(5)
OIL AND GAS PRODUCTION AND REFINING	6.81	51.58	4.28	7.89	1.65	4.78
PIPLINES EXCEPT NAT. GAS	0.07	0.04	0.01	0.06	0.12	0.53
GAS PRODUCTION AND DISTRIBUTION	2.29	2.38	0.23	2.14	0.58	3.69
MOTOR VEHICLES AND EQUIPMENT	2.54	0.00	0.74	2.34	1.12	2.09
PAPER AND ALLIED PRODUCTS	2.16	3.84	0.75	2.10	0.94	2.23
CHEMICALS AND ALLIED PRODUCTS	4.45	4.73	2.69	4.32	2.20	1.97
ELECTRIC SERVICES	9.97	1.48	0.86	9.04	1.87	4.83
FOOD MANUFACTURING	2.76	0.07	2.49	2.66	2.05	1.30
MACHINERY, EXCEPT ELECTRICAL	2.30	4.11	1.54	2.27	2.22	1.02
ELECTRICAL AND ELECTRONIC EQUIPMENT	2.76	0.06	0.02	2.57	1.84	1.40
COMMUNICATION	8.95	0.02	0.01	8.14	2.37	3.44

Source: "Corporation Income Tax Returns" Source Book 1991 Statistics of Income, SOI Division, Dept. of Treasury.

Table 2. Present Value of Allowed Depreciation by Asset Life, current system (as percent of initial capital cost)

	5 Year	7 Year	10 Year	15 Year
4% discount 2% inflation	90.3	86.3	78.2	61.6
8% discount 4% inflation	82.3	75.8	68.8	54.5
16% discount 8% inflation	70.2	61.1	55.7	45.0

Ms. DUNN. Thank you very much, Mr. Beghini.

We will move on then with Mr. McCallum.

STATEMENT OF JOHN D. McCALLUM, VICE PRESIDENT, CORPORATE TAX, POTOMAC ELECTRIC POWER CO., ON BEHALF OF THE EDISON ELECTRIC INSTITUTE

Mr. MCCALLUM. Good afternoon, Madam Chairwoman and members of the committee.

I am John D. McCallum, vice president of corporate tax of Potomac Electric Power Co., which is more commonly known in this city as Pepco. I am here today to testify on behalf of the Edison Electric Institute, referred to as EEI and Pepco.

EEI is the association of the Nation's investor-owned electric utility companies. Our member companies provide electric service to 76 percent of all ultimate electric customers in the Nation. We appreciate the opportunity to appear today to present our views on the neutral cost recovery system proposed in H.R. 9.

In summary, let me state that as the most capital-intensive industry in our Nation, with currently over $500 billion in plant and equipment, we strongly support the concepts contained in this neutral cost recovery proposal. We believe it would reduce the cost of electricity for all our customers and therefore the cost of virtually all U.S. produced goods and services.

We also strongly support an attempt to achieve the goals of this proposal to the extent we can afford to do so in a deficit neutral manner without tax increases. Our analysis of this proposal leads us to the following three principal conclusions, each of which along with some certain general recommendations are discussed in greater detail in our written statement.

First, in regard to achieving cost recovery neutrality, as highlighted by the chart on page 4 of our written statement, the proposed NCR system will reduce the bias against capital investment, but it will not achieve a fully neutral nor equal system of cost recovery for all taxpayers. Capital investment in long-life property, that is, property with a 15-year or greater life, is the most disadvantaged under current law, and it will continue to be substantially disadvantaged under the proposed NCR system.

In order to achieve a truly neutral depreciation system, capital investment in this long-life property will need to receive equal treatment to that of other property under the proposed system, including the full neutral cost recovery ratio. Such treatment is critical in order to achieve the objective of neutral cost recovery.

Our second area of discussion is in regard to neutral cost recovery in competition. We believe the proposed NCR system should increase our Nation's ability to create jobs and to compete internationally. We also strongly believe that the proposed NCR system should be fundamentally clarified by this committee to ensure a level playingfield for all domestic competitors.

Our principal concern here is that our industry, once highly regulated, is rapidly moving toward less regulation and more competition. As a result, nontraditional electric suppliers compete with our industry, and we need to ensure they have the same tax treatment under the tax law as we do. This could be achieved by providing that similarly situated property, regardless of ownership form or guideline class should have the same neutral cost recovery treatment.

Our third area of discussion is in regard to environmental property. We wish to point out to the committee that the proposed NCR system does not incorporate section 169 of the Internal Revenue Code which provides for 60-month amortization of qualifying pollution control facilities.

As highlighted by the chart on page 9 of our statement, it is important to include such property because the cost recovery mechanism provided by section 169 has been substantially eroded over the years by tax law changes. This could be addressed by including such equipment in the 5-year life category.

We also recommend that the AMT be generally modified to exclude adjustments for recovery of capital investment in environmental equipment. We believe such treatment is consistent with good public policy.

In conclusion, we strongly support the concepts contained in the proposed NCR system, and we urge your consideration of our comments.

We thank the committee for the opportunity to present our views today, and we are available for any questions that you may have.

Thank you.

[The prepared statement follows:]

STATEMENT
OF
JOHN D. MCCALLUM
VICE PRESIDENT - CORPORATE TAX
POTOMAC ELECTRIC POWER COMPANY
ON BEHALF OF
THE
EDISON ELECTRIC INSTITUTE
AND THE
POTOMAC ELECTRIC POWER COMPANY

REGARDING
THE
NEUTRAL COST RECOVERY SYSTEM
OF
TITLE II OF H.R. 9
THE JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995

BEFORE THE
COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES

January 26, 1995

Good day, Mr. Chairman and members of the Committee. I am John D. McCallum, Vice President - Corporate Tax of Potomac Electric Power Company (Pepco), an investor-owned electric utility which serves over 1.9 million people in the metropolitan area of our Nation's capital. I am here today to testify on behalf of the Edison Electric Institute (EEI) and Pepco. EEI is the association of the Nation's investor-owned electric utility companies. Member companies of EEI generate approximately 79 percent of all the electricity in the country and provide electric service to 76 percent of all ultimate electric customers in the Nation. We appreciate the opportunity to appear today to present our views on the Neutral Cost Recovery (NCR) System proposed in H.R. 9, The Job Creation and Wage Enhancement Act of 1995.

In summary, we applaud the introduction of Chairman Archer's proposal providing for the NCR system and we strongly support it. We believe it will reduce the cost of electricity for our customers and therefore the cost of virtually all U.S.-produced goods and services. Concurrent with its enactment, we also strongly support a congressional commitment to pay for this proposed NCR system through prudent reductions in the cost of the federal government and not from tax increases. Our analysis of the proposed NCR system leads us to the following conclusions and recommendations, each of which is discussed in greater detail later in our statement:

1) <u>Cost Recovery Neutrality</u>

The proposed NCR system will reduce the bias against capital investment but it will not achieve a fully neutral, nor equal system of cost recovery for all taxpayers. Capital investment in long-lived property is disadvantaged under current law and will continue to be substantially disadvantaged. In order to achieve a neutral depreciation system, capital investment in long-lived property (<u>i.e.</u>, property with a 15-year or greater life) also will need to receive the full neutral cost recovery ratio, including the 3.5% real rate of return. Such treatment is critical in order to achieve the objective of neutral cost recovery.

If cost recovery neutrality is not achievable under our current income tax system, then it may be appropriate to examine alternative tax systems in lieu of the income tax. Such systems are used elsewhere in the world and focus more on taxing consumption rather than savings and investment. In that regard, we commend Chairman Archer and other members of this Committee on both sides of the aisle who have stated their intent to more closely examine such alternatives later in this Congress. As we have closely examined the issue of broad-based consumption taxes, we would be pleased to share our analysis and conclusions with this Committee in the appropriate forum. We look forward to that opportunity.

2) **Neutral Cost Recovery and Competition**

The proposed NCR system should increase our Nation's ability to create jobs and to compete internationally. We also strongly believe that the proposed NCR system should be fundamentally clarified by this Committee to ensure a "level playing field" for all domestic competitors. This could be achieved by providing that similarly situated property, regardless of ownership form or guideline class, should have the same neutral cost recovery treatment.

3) **Environmental Property**

We are also concerned that the proposed NCR system does not incorporate Section 169 of the Internal Revenue Code (IRC) which provides for 60-month amortization of qualifying pollution control facilities. This could be addressed by allowing environmental property to be included within the five-year NCR system life category similar to previously introduced H.R. 4299[1]. The inclusion of such equipment in the five-year NCR system life category is important because the cost recovery mechanism provided by Section 169 has been substantially eroded by tax law changes. The AMT should also be generally modified to exclude adjustments for recovery of capital investment in environmental equipment.

4) **Other Recommendations**

We have also included herein certain other recommendations regarding tax normalization and the proposed quarterly convention. We strongly support the continuation of normalization of all book to tax timing or temporary differences attributable to the NCR system. We have concluded that the adjustments attributable to the proposed NCR ratio are not temporary differences; however, EEI has not concluded whether such adjustments should or should not be subject to mandatory normalization. We also recommend that the Committee consider minimizing the administrative cost and burden of the proposed quarterly convention by adopting an annual convention.

Each of these conclusions/recommendations is discussed more fully below.

Cost Recovery Neutrality

The electric utility industry (Industry) is the most capital intensive industry in the Nation with over $500 billion of capital investment in plant and equipment. Our Industry invests over $2 of capital for each $1 of annual revenue, substantially more than most other industries. We strongly support the goal of enacting a

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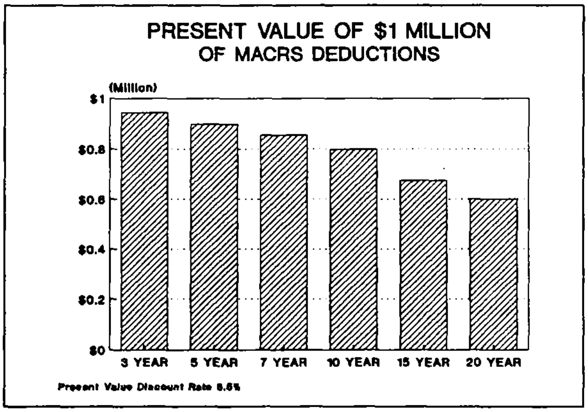
[1] H.R. 4299, introduced on February 25, 1992, would have established a new class of property identified as "environmental property" with a five-year recovery period.

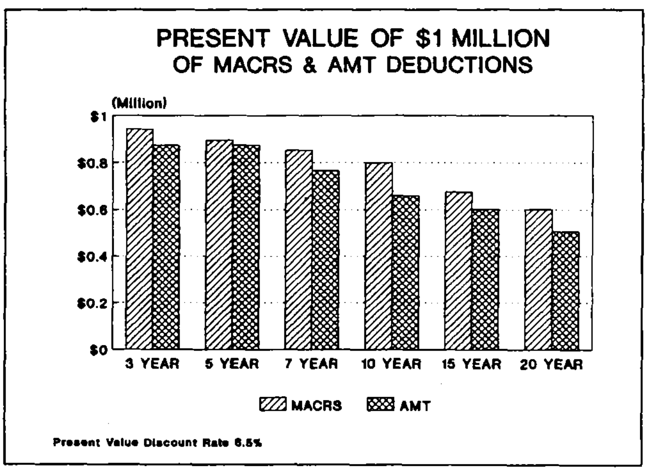
depreciation system which treats recovery of all taxpayers' capital investments equally. Provided below is a discussion and comparison of the current depreciation system and the proposed NCR system.

The Current Depreciation System - MACRS

The current depreciation system, the Modified Accelerated Cost Recovery System (MACRS), contains substantial bias against capital intensive industries with long-lived equipment. For our Industry, the majority of our capital investment falls into the 15 and 20-year MACRS categories. As highlighted by the following chart, the present value of the depreciation deductions provided by our current depreciation system do not provide a neutral, nor equal cost recovery system for taxpayers.



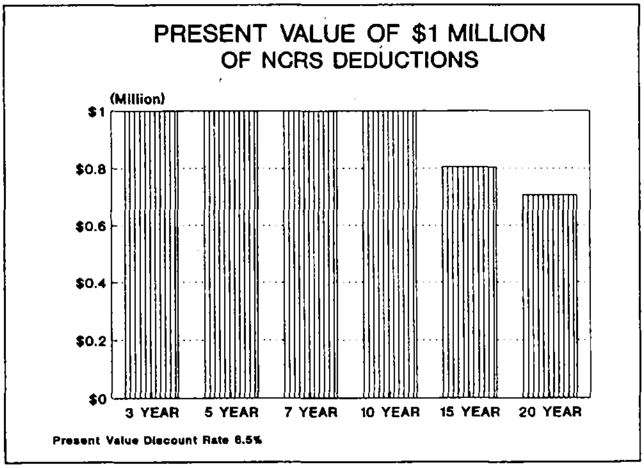
Additionally, current depreciation deductions allowed under our regular tax system are eroded for many taxpayers by an AMT system which penalizes capital investment. The following chart demonstrates the effect of the AMT on MACRS taxpayers.



In summary, the current depreciation system contains a substantial bias against capital investment in long-lived equipment and a key goal of any proposed recovery system should be the elimination of such bias. All taxpayers should be treated equally with respect to their capital investment.

The Proposed Neutral Cost Recovery System

The proposed NCR system will reduce the bias against capital investment but it will not eliminate such bias for all taxpayers. As highlighted by the following chart, substantial bias will still exist against long-lived equipment.



The proposed NCR system helps to reduce the bias against capital investment by providing a 3.5 percent real rate of return for property with three, five, seven and ten-year MACRS lives. The proposal also provides an inflation adjustment for all property including those with 15 and 20-year MACRS lives and real property.

The proposed system creates a new two-tier depreciation system where one group of assets receives a 3.5 percent real rate of return and others do not. This raises new concern about attaining equity and fairness in a competitive environment where we should be seeking to achieve a level playing field for all domestic business. This concern arises because the NCR system will not fully correct the present bias toward longer-lived equipment. The solution to this problem is to provide all NCR system assets ultimately with the same equivalent present value for their cost recovery deductions. In order to achieve a truly neutral depreciation system, capital investment in long-lived property (i.e., property with a 15-year or greater life) will also need to receive the full neutral cost recovery ratio, including the 3.5% real rate of return. Such treatment is critical in order to achieve the objective of neutral cost recovery.

If cost recovery neutrality is not achievable under our current income tax system, then it may be appropriate to examine alternative tax systems in lieu of the income tax. Such systems are used elsewhere in the world and focus on taxing consumption rather than savings and investment. In that regard, we commend

Chairman Archer and other members of this Committee on both sides of the aisle who intend to more closely examine such alternatives later in this Congress. As stated previously, we have closely analyzed this issue. We would be pleased to make our findings available to the Committee.

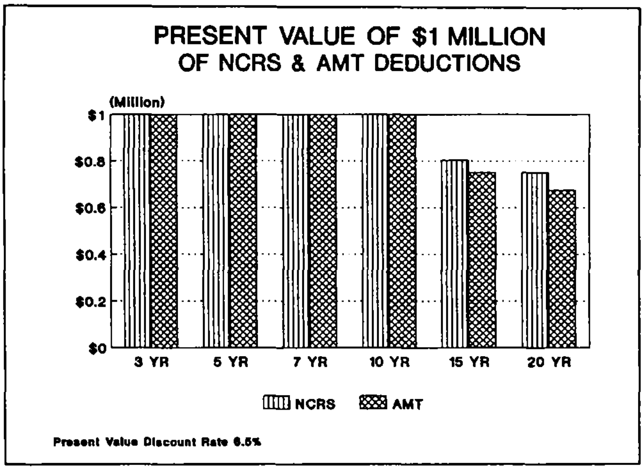
The NCR System and the AMT

With regard to the NCR system and the AMT, we commend Chairman Archer for the proposed adoption of the NCR system modifications to the AMT which will help ensure both compatible and reasonable treatment thereunder. Highlighted below is a table which compares the life and method used for the regular tax and AMT purposes under the proposed NCR system.

SUMMARY TABLE OF
NCR SYSTEM
LIFE/METHOD

Regular Tax		AMT		NCR Ratio	
NCR Property Life	Base Depreciation Method	AMT Life	AMT Method	Real Return Adjustment (3.5%)	Applicable Inflation Adjustment
3 Yr	150% DB	5 Yr	150% DB	Yes	Yes
5 Yr	150% DB	6 Yr	150% DB	Yes	Yes
7 Yr	150% DB	10 Yr	150% DB	Yes	Yes
10 Yr	150% DB	16 Yr	150% DB	Yes	Yes
15 Yr	150% DB	20 Yr	150% DB	No	Yes
20 Yr	150% DB	28 Yr	150% DB	No	Yes

As shown in the graph which follows, although the AMT lives are longer than regular tax lives under the NCR system, over time the NCR ratio results in the AMT providing a neutral cost recovery system for all taxpayers, except those with capital investments in long-lived property.



In order to achieve a neutral AMT cost recovery system for all taxpayers, the full NCR ratio, including the 3.5% real rate of return, should be applied to all property.

In addition, the goal of the AMT should be one of revenue neutrality with regard to the costs incurred to meet environmental regulation. Currently, however, the AMT includes adjustments for recovery of capital investment in environmental equipment, such as pollution control property. This can result in heightened AMT costs, which increase the overall cost of environmental compliance. Adjustments for environmental property should be excluded from the AMT computation in order to achieve AMT neutrality with regard to environmental policy. Specifically, Section 56(a)(5) relating to the AMT adjustment for pollution control equipment should be eliminated.

Neutral Cost Recovery and Competition

EEI wishes to emphasize the importance of having a neutral cost recovery system which helps our ability as a nation to compete and to create jobs in the domestic economy. The Industry's views on certain facets of the effects of neutral cost recovery on international competition and competition in the domestic economy are discussed below.

International Competition

The cost of producing electricity by our Industry is borne by our customers who, in turn, include such costs in the price of their U.S.-produced goods and services. Virtually every product or service produced in the U.S. includes as a part of its price the cost of the electricity consumed. The cost of electricity is in part a function of the capital cost recovery system available under the tax law for capital investment in such equipment. If other nations have better cost recovery systems, which many do, the cost of their products and services will be proportionately less. We, as a Nation, must have a cost recovery system equal to our competitors if we are to compete and prosper.

Today our Nation enjoys the best electric system in the world, thanks in no small part to the wisdom of this Committee in the past. However, other nations are rapidly investing in new electric infrastructure. We estimate that our Industry also will be investing substantially in new plant and equipment in the amount of $75 billion over the next three years. During the period from 1995 through 2002 based on current plans, we expect to invest between $1.5 and $4.0 billion each year for environmental equipment as a result of the Clean Air Act of 1990. A neutral cost recovery system which reduces the cost of capital investment will help our Nation compete in the new one-world economy.

Competition in the Domestic Economy

Our Industry, once highly regulated, is rapidly moving toward less regulation and more competition as a result of energy policy changes at the federal level, including the enactment of the Public Utility Regulatory Policy Act of 1978 (PURPA) and the recently enacted Energy Policy Act of 1992. Non-traditional and non-regulated competitors in the electric business have established themselves and are growing rapidly. We need to ensure a level playing field for all competitors in our industry, be they investor-owned utilities, independent power producers, co-generators, or income tax exempt utilities.

Any cost recovery system enacted should fundamentally ensure that similarly situated property, regardless of form of ownership or guideline class, should have the same neutral cost recovery treatment. Today, biases exist which need to be corrected. For example, in certain cases, if a turbine electric generator is placed in service by a co-generator, the current MACRS depreciation treatment for the turbine electric generator is determined by the co-generator's business activity. As a result, a shorter life, be it seven years, ten years or fifteen years, and in most cases a more accelerated depreciation method is available dependent upon the co-generator's business activity versus the electric utility's business activity which requires a 20-year life with a 150 percent declining balance depreciation method. This bias as it exists in the current MACRS is heightened by the proposed NCR system. As currently drafted, the NCR system increases the unlevel playing field and unfair competition which should be corrected to ensure neutral cost recovery for all competitors.

Similarly, as technological advances occur, which result in opportunities and infrastructure investments in the information super highway, capital investment by electric utilities in technologies (such as fiber-optics) should not receive any different cost recovery treatment than other taxpayers with similarly situated property. We urge the Committee, for competitive reasons, to ensure the NCR system fundamentally provides that similarly situated property, regardless of ownership form or guideline class, will have the same neutral cost recovery treatment.

EEI wishes to further emphasize that substantial other competitive biases exist for certain segments of the electric utility business. The proposed NCR system, as modified by our discussion above, would help to overcome such bias. For example, governmental and tax exempt electric utilities (such as municipals and cooperatives) already have, in effect, a neutral cost recovery system because they are exempt from federal income tax. Furthermore, they receive huge subsidies from the federal government in the form of low interest or tax exempt loans. The cost of these subsidies is borne for the most part by U.S. taxpayers other than by the customers of the governmental and tax-exempt electric utilities. This means that customers of the investor-owned electric utilities, which serve 76 percent of all ultimate electric customers in our Nation, bear the unsubsidized cost of their electricity plus as U.S. taxpayers a portion of the cost of subsidizing the customers of governmental and other tax-exempt electric utilities. Although these governmental subsidies had their time and place in helping to provide electrification to every home in America, they are now misplaced in this new era of budget deficits, deregulation and competition. These subsidies should be thoroughly reviewed.

Environmental Property

We are also concerned that the proposed NCR system does not incorporate Section 169 of the IRC which provides for 60-month amortization of qualifying pollution control facilities. This can be addressed by allowing environmental property to be included within the five-year NCR system life category similar to previously introduced H.R. 4299[2]. The cost recovery treatment of capital investment in environmental property such as pollution control equipment has been substantially eroded by tax law changes and is currently counterproductive to good public policy. The AMT should also be generally modified to exclude adjustments for recovery of capital investment in environmental equipment.

The cost recovery benefit of current law Section 169 has been substantially eroded by the special limitations of Sections 169(f) and 291(a)(5) and by Section 56(a)(5) of the AMT. Currently, for regular tax purposes, only 60 percent of qualifying pollution control capital investment is eligible for amortization under Section 169 as a result of the limitations of Sections 169(f) and 291(a)(5). The remaining 40 percent of the qualifying pollution control capital investment is required for regular tax purposes to be depreciated over the 20-year MACRS life for our Industry. This cost recovery benefit has for AMT purposes been further eroded by Section 56(a)(5) of the IRC, which provides that the total basis of the capital investment in the pollution control equipment must be amortized for purposes of computing the AMT preference adjustment over 28 years, using the straight-line method. Capital investment in environmental property should be included in the five-year NCR system life category.

Additionally, the definitions of qualifying pollution control property need to be updated to include expenditures and new technologies to comply with the Clean Air Act of 1990[3]. This definition should include emissions monitoring equipment, fuel switching, blending or co-firing modifications, boiler repowering modifications, nitrogen oxide controls, flue-gas desulfurization and/or other sulfur-dioxide controls, fluidized bed combustion, and coal gasification facilities, advanced coal cleaning facilities and air toxics control equipment and other emerging environmental

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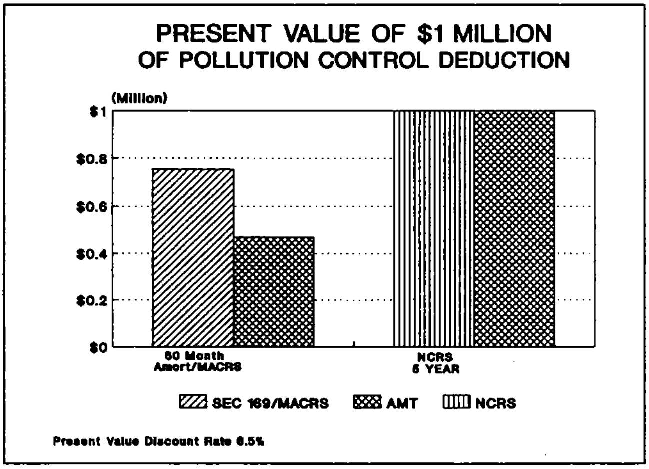
[2] H.R. 4299, introduced on February 25, 1992, would have established a new class of property identified as "environmental property" with a five-year recovery period.

[3] H.R. 4299 defined "environmental property" as follows: Environmental property is defined as a new identifiable item of property which is used in connection with a plant or other property in operation before January 1, 1991, to prevent, abate, or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants (including dust), contaminants, wastes, or heat, and property which monitors the creation or emission of pollutants (including dust), contaminants, wastes, or heat. The term includes only property which does not significantly increase the output or capacity, extend the useful life, or reduce the total operating costs of such plant or other property (or any unit thereof), or alter the nature of the manufacturing or production process or facility. Special rules would be applicable to buildings and leased property.

technologies. Our Industry estimates, based upon current plans, that it will invest between $1.5 to $4.0 billion each year in such equipment during the period 1995 through 2002 as a result of the Clean Air Act of 1990. As shown below, the cost recovery for capital investment in environmental property such as pollution control equipment under the current MACRS and AMT law highlight the need for the inclusion of environmental property in the five-year NCR system life category.



Other Recommendations

Normalization

Although our Industry strongly believes that normalization of depreciation book to tax timing or temporary differences is the proper method of tax accounting required to allocate tax expense to our customers, we have concluded that the permanent differences created by the unique nature of the neutral cost recovery ratio are not temporary differences. We recommend the NCR system be specifically clarified to state that the temporary differences related to assets under the NCR system would be subject to the mandatory normalization provisions of Section 168 of the IRC consistent with current law. The Industry has not reached a conclusion regarding whether or not the adjustment attributable to the NCR ratio should or should not be subject to mandatory normalization. We would be pleased to work with the Committee in regard to this matter.

Quarterly vs. Annual Calculations

The proposed NCR system requires ongoing calculations to be applied to property relating to the quarter the property was placed in service. This requirement adds substantial ongoing complexity and resulting administrative cost for both business and government. We recommend the Committee consider minimizing such administrative burden by adopting an annual rather than a quarterly convention.

Conclusion

In summary, we strongly support Chairman Archer's proposed NCR system consistent with our comments provided herein. The proposed NCR system is of benefit to our customers and will reduce the cost of virtually all U.S.-produced goods and services. We conclude it will help make America more competitive and it will help create more jobs. A key goal for a fair and equitable neutral cost recovery system is for it to enable our Nation to be more competitive and to provide a level playing field for all to compete. We urge the Committee, to ensure the proposed NCR system fundamentally provides that similarly situated property, regardless of ownership form or guideline class, will have the same neutral cost recovery treatment. Finally, we recommend the proposed NCR system be modified to include environmental equipment in the five-year NCR system depreciation category and that such equipment be eliminated from being subject to adjustments under the AMT. We thank the Committee for the opportunity to present our views and we look forward to working with you in the future with regard to this proposal and other important matters.

Ms. DUNN. Thank you very much, Mr. McCallum.

We will move along now with John Huber.

STATEMENT OF JOHN HUBER, GOVERNMENT AFFAIRS COUNSEL, PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. HUBER. Madam Chairwoman and members of the committee, thank you for providing an opportunity to present testimony on the legislative proposals to improve the cost recovery system for business investment.

PMAA is a federation of 41 State and regional trade associations representing more than 10,000 independent small business marketers throughout the United States. The impact of the current schedules for depreciating property are a strong concern to marketers and are clearly inappropriate.

There are two main areas of concern to marketers. First is the impact of the recently enacted Omnibus Budget Reconciliation Act of 1993, and the uniform 15-year schedules for all intangible property. This has a great impact on marketers and heating oil retailers in particular.

The other area of concern is the 39.5 year depreciation schedule for nonresidential real property, which prior to OBRA was 31.5 years. For many marketers who deliver fuel in bulk, the value of the business relates directly to the customer served.

A strong customer list and an extensive penetration of a particular geographic market makes for a valuable business. Without such a list, the business is merely a bulk plant, a small office building, and a few trucks. The customers are the business. Unfortunately customers do not last forever. Homeowners move, farmers sell out, trucking companies go bust. Thus, a customer base is always eroding.

Prior to the enactment of OBRA, most heating oil dealers amortized their customer list over a 7 to 10 year period. This time was recognized by the courts. The move to 15 years damaged these small businesses.

A second area of concern to petroleum marketers are covenants not to compete. Under common law these covenants must generally be no longer than 5 years.

In the heating oil industry the value of this covenant not to compete will generally range between 20 and 40 percent of the value of the business. A depreciation schedule of 15 years puts a large gap between the value of the covenant and its depreciation schedule and undermines the value of an ongoing business.

A third area of concern involves the depreciation schedules for nonresidential real property. The primary investment activity of our marketers involves the construction of service stations or gas station convenience stores.

Marketers are now having to replace many of their tanks that are currently in the field. This has led to a great deal of investment by petroleum marketers as they decide what stations to continue to operate and how their stations should be modernized, either through replacement or renovation. Under the existing code, some of the investments in gas station convenience stores are subject to a 39.5 year straight line depreciation schedule.

Industry practice is that these facilities are either worn out or no longer suitable for the market after 15 years, and therefore marketers who are investing in the industry are in a much faster schedule than allowed by the code.

PMAA believes that these extended depreciation schedules for this type of property embodied in section 168 are inappropriate. PMAA would encourage the committee to reexamine the existing schedules in section 168 and shorten the schedules or create additional classes of nonresidential real property.

PMAA is pleased that the committee is considering a capital gains tax reduction. We believe such an approach will spur investment and provide the appropriate rewards for those businesses investing in America's future. We believe that this item should be a top priority for enactment.

Finally, PMAA is very supportive of the provision to allow expensing of a small part of the capital investment in each year. An increase from $17,500 to $25,000 is a small increase, but it will be helpful.

PMAA is very pleased that the committee has developed a very solid approach to improve the climate for capital investment. These capital investments are clearly the key to continued growth.

We do believe that the committee should consider taking steps to bring the existing depreciation schedules of the code into closer conformity with actual industry practice. We believe the practice in recent years of extending the schedules to raise revenues has seriously undermined the principal of matching revenues and expenditures, which is the basis for an income tax.

Finally, PMAA remains concerned with the excise tax collection procedure and looks forward to working with this committee in the future and significant reform to those changes.

Thank you.

[The prepared statement follows:]

TESTIMONY OF JOHN HUBER
PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. Chairman, and members of the Committee, thank you for providing an opportunity to present testimony on the legislative proposals to improve the cost recovery system for business investments. The Petroleum Marketers Association of America (PMAA) is a federation of 41 state and regional trade associations representing more than 10,000 independent petroleum marketers throughout the United States. These marketers sell in excess of forty percent of the gasoline, 75 percent of the home heating oil and 60 percent of the diesel fuel consumed in this country. Eighty-nine percent of PMAA's membership is classified as small business under size categories established by the Small Business Administration.

The impact of the current schedules for depreciating property are of strong concern to marketers, and most believe that the schedules established are inappropriate. There are two main areas of concern to marketers. First, is the impact of the recently enacted Omnibus Budget Reconciliation Act of 1993 (OBRA) and the uniform fifteen year schedules for all intangible property. This has a great impact on marketers and heating oil dealers in particular. There is a great deal of consolidation in this industry, and the value of the firm is generally the value of the intangibles. Second, is the impact of the 39.5 year depreciation schedule for non-residential real property, which prior to OBRA was 31.5 years.

INTANGIBLE ASSETS

Briefly, PMAA members have a variety of different methods of delivering petroleum products to their customers. First, PMAA members deliver heating oil directly to homeowners and commercial customers. Second, many members deliver motor fuels to farmers, trucking companies, and construction crews who need fuel delivered to them or to a particular site.

For marketers who are active in these two areas, the value of the business relates directly to the customers served. A strong customer list and an extensive penetration of a particular geographic area makes for a valuable business. Without such a list, the business is merely a bulk plant, a small office building, and a few trucks, whose value is reduced with every new environmental regulation. **The customers are the business.**

Unfortunately, customers do not last forever. Homeowners move. Farmers sell out. Trucking and construction companies go bust. Additionally, some customers find the service or price of a competitor to be better and begin purchasing product from that company. Additionally, the Clean Air Act Amendments will require many customers to transfer their fleets to alternative fuels. As a result, they will not only be lost to a particular marketer, but they will be lost to the entire petroleum marketing industry.

Mr. Chairman, what I am trying to say is that a customer list is the most important asset for many petroleum marketers, but unfortunately, it does not normally last 15 years. Prior to the enactment of this legislation, most heating oil dealers amortized their customer list over a seven to ten year period. This time was recognized by the courts, and is in line with surveys indicating that, on average, homeowners move every six years. The move to 15 years was clearly inappropriate.

A second area of concern to petroleum marketers are covenants not to compete. Because many of the companies operated by PMAA members were developed through the hard work of a single individual who penetrated a market and developed a loyal customer base, businesses who acquire that company often enter into a contract preventing that individual from becoming a competitor. Under common law, those covenants must have reasonable terms, which generally means five years.

In the heating oil industry, the value of this covenant not to compete will generally range between 20 percent and 40 percent of the value of the transaction. A depreciation schedule of fifteen years would put a large gap between the value of the covenant and its depreciation schedule and could substantially harm the acquiring company.

TANGIBLE ASSETS

A second area of concern involves the depreciation schedules for non-residential real property. The primary investment activity of our marketers involves the construction of service stations or gas station convenience stores. Under, the environmental laws, marketers are now having to replace many of their tanks that are currently in the field. This has led to a great deal of investment by petroleum marketers as they decide what stations to continue to operate, and how their stations should be modernized either through replacement or renovation. This heightened level of activity will continue for at least four more years.

Under the existing code and pursuant to Internal Revenue Service guidance, some of the investments in gas station convenience stores are subject to a 39.5 year straight line depreciation schedule. Industry practice is that these facilities are either worn out, not modern enough to attract customers, or no longer suitable to the market after approximately fifteen years, and therefore marketers who are investing in the industry are depreciating the stations much more quickly on their own books than the Internal Revenue Code allows for tax accounting.

PMAA believes that these extended depreciation schedules for this type of property embodied in section 168 are inappropriate. PMAA would encourage the Committee to reexamine the existing schedules in Section 168 and shorten the schedules or create different classes of non-residential real property.

JOB CREATION AND WAGE ENHANCEMENT ACT

PMAA is very pleased that Congress is now considering ways to improve the depreciation deductions for businesses. In particular we are pleased that the Committee is considering a capital gains tax reduction. We believe such an approach will spur investment and provide the appropriate rewards for those businesses investing in America's future. We believe that this item should be a top priority for enactment.

We also believe that an inflation adjustment within the capital gains is vital. Taxing gains which emanate from inflation is clearly inappropriate and has undercut the value of many productive investments and created a windfall for the Treasury.

PMAA, however, is concerned with the methodology to allow for an improved cost recovery system. In particular, a change from the 200 percent declining balance to a 150 percent declining balance gives concern to PMAA. This reduced schedule would result in an immediate negative impact on marketers investing in personal property. Marketers invest considerable sums in the assets affiliated with their real property and make considerable investment in rolling stock. A delayed depreciation schedule would thus be harmful.

Finally, PMAA is very supportive of the provision to allow expensing of a small part of the capital investment in each year. While, $25,000 is a small percentage of a marketer's likely investment, it would certainly be a benefit to marketers.

CONCLUSION

PMAA is very pleased that the Committee has developed a very solid approach to improve the climate for capital investment. These capital investments are the key to continued growth in America and are thus of vital interest to both business and their employees.

We do believe that the Committee should consider taking steps to bring the existing depreciation schedules of the Code into closer conformity with actual industry practice. We believe the practice in recent years of extending the schedules to raise revenues has seriously undermined the principle of matching revenues and expenditures which is the basis for an income tax. We would thus respectfully encourage the Committee to more closely examine those schedules and take steps to make the schedules reflect economic reality.

Ms. DUNN. Thank you very much, Mr. Huber.

We will do our wind-up speaker, Dr. Martin Sullivan.

STATEMENT OF MARTIN A. SULLIVAN, PH.D., ADJUNCT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. SULLIVAN. Thank you, Madam Chairman, and distinguished members of the committee.

My name is Martin Sullivan. I am a self-employed economic consultant and an adjunct scholar at the American Enterprise Institute. It is an honor for me to be here today, and I hope my views will be helpful to you.

The neutral cost recovery system is an approach to tax depreciation that is radically different from any other. Under NCRS, $100 of equipment with a useful life of 5 years generates approximately $120 of depreciation deductions. A $100 investment in a building generates approximately $300 of depreciation deductions.

The key feature of NCRS depreciation is the adjustment of depreciation allowances for inflation and for the time value of money. This adjustment increases deductions so that their present value is equivalent to expensing.

Expensing is the ultimate in accelerated depreciation. Where debt financed property is expensed, that property's effective tax rate is negative, thus NCRS goes beyond relief and provides a subsidy for most business investment in new equipment.

Negative effective tax rates mean that new assets will generate more deductions than income. Under NCRS many capital-intensive firms will be able to eliminate their corporate income tax liability, even though they are profitable.

There is no doubt that NCRS will result in an enormous increase in the buying and selling of tax benefits. Because of the passive loss rules, partnership tax shelter activity on the scale like that before 1986 is not possible. But the existence of the passive loss rules does not mean that there will not be tax shelters as a result of NCRS. It only means that their form will change.

Tax shelter activity will shift to the corporate level. In order to convert unusable tax deductions into cash, taxless corporations will engage in leasing transactions which will effectively allow them to sell their tax benefits.

In addition to tax-motivated leasing, NCRS will clearly provide a large tax incentive for mergers and acquisitions. This is the granddaddy of sheltering transactions. In the typical case, a capital-intensive firm that is generating deductions in excess of income, will put excess deductions to work by merging with a profitable labor-intensive firm.

If enacted, NCRS would impose unduly complex and costly tax rules on U.S. businesses. Sometimes complexity in the code is unavoidable, but that is not the case in this situation. What is so frustrating about the complexity of NCRS is that the same economic benefits can be provided much more simply. This is the Rube Goldberg of tax breaks. NCRS forces taxpayers on Main Street to face a whole new set of complicated rules and regulations so that the folks inside the beltway can game the budget rules.

NCRS will provide the most generous system of capital recovery ever enacted into Federal tax law. Yet, it is entirely possible for

NCRS to be scored officially as raising revenue. You don't need to be an economic expert to know there is something fishy about this, and this point will not be lost on the bond traders on Wall Street.

For purposes of preparing this testimony, I constructed a depreciation revenue-estimating model. Like the Treasury Department's estimates, my model shows that the cash flow effects of NCRS are net positive for the government over the first 5 years, but afterward, NCRS rapidly turns into a big loser for the government. My model estimates the total 10-year cost in terms of cash flow at $150 billion. But even these long-term cash estimates do not accurately portray the costs of this proposal.

Our current methods of accounting for revenue changes are flawed. We only score cash flows and we do not score the real economic costs. In order to assess the real costs of this proposal, I estimated the cost of an investment tax credit economically equivalent to NCRS. I believe this is the best measure of the true cost of NCRS.

When the cost of an economically equivalent tax credit is estimated, NCRS can be seen for what it really is, a budget buster of monumental proportions. What was scored in the 5-year window as a small increase in revenue under conventional cash flow accounting becomes a $160 billion revenue loser in the first 5 years. Over the 10-year budget window, the total real economic cost to the government of NCRS is estimated to be $370 billion.

It is this type of discrepancy between official cash flow estimate and real economic costs that will spook the financial markets. If NCRS is enacted and the hundreds of billions of dollars of real costs are not matched by real spending cuts or tax increases of similar magnitude, long-term interest rates will rise. Because of this rise in interest rates, and the crowding out of private investment by increased Federal debt, there is a significant chance that NCRS could have detrimental effects on capital formation.

This concludes my oral testimony. I am very grateful to the committee for this opportunity to share my views.

[The prepared statement follows:]

Testimony on the "Neutral Cost Recovery System"

BY

Dr. Martin A. Sullivan

Adjunct Scholar
American Enterprise Institute

Before the Committee on Ways and Means
of the
United States House of Representatives
104th Congress

January 26, 1995

Good Morning Mr. Chairman and distinguished Members of the Committee. My name is Martin Sullivan. I am a self-employed economic consultant and an Adjunct Scholar at the American Enterprise Institute. Over the past 15 years I have conducted research and analysis in academia, for the Congress, for the U.S. Treasury Department, and for clients in the private sector, on tax incentives for capital formation. It is an honor to be here today and I hope my views will be helpful to you.*

1. Some Basics About NCRS

The Neutral Cost Recovery System (NCRS) is an approach to tax depreciation that is radically different from any other that has existed since the inception of the income tax. By statute and by regulations, previous Congresses and Administrations have on numerous occasions tinkered with depreciation methods and lives in such a manner that affected only the timing of deductions. Whatever system they devised, a $100 purchase of depreciable capital always got a $100 of deductions. Under NCRS depreciation, every $100 expenditure for depreciable capital will routinely generate deductions substantially in excess of $100. In the example presented at the end of this testimony (Table 1), $100 of equipment with a useful life of 5 years generates depreciation deductions of approximately $120 over the its life. Similar calculations show a $100 building with a useful life of 39 years generating approximately $300 of depreciation deductions over its life.

NCRS would be available to both corporate and noncorporate taxpayers for capital placed in service after December 31 of 1994. Taxpayers could elect the NCRS on a property-by-property basis, and, importantly, NCRS would also be available for computing deductions under the alternative minimum tax.

NCRS divides depreciable property into two categories. Property with a recovery period of 10 years or less would be required to make three changes from current law: (1) replace the 200-percent declining balance method with the less accelerated 150-percent declining balance method; (2) multiply these allowances by a factor to account for cumulative amount of inflation since the asset was placed in service; and (3) again multiply by a factor representing the cumulative real return

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* The views expressed in this statement are those of the author and do not necessarily reflect those of the American Enterprise Institute.

that could have been earned by the amount of that deduction since the time the asset was placed in service. For property with a useful life of greater than ten years, the only change from current law is that allowances are adjusted for inflation.

Adjustments (2) and (3)--which may be referred to jointly as the "cost recovery adjustment"--make sure that no matter in what year a deduction is taken, it is equal in present value to taking the unadjusted deduction in the first year. Thus, applying a cost recovery adjustment to all the depreciation allowances over the useful life of an asset results in total deductions equal in present value to a complete write-off of the asset in the first year. Completely writing off assets in the first year is commonly referred to as "expensing."

It is noteworthy that the cost recovery adjustment achieves the economic equivalent of expensing not only under the prescribed 150-percent declining balance, but also under straight-line depreciation, the 200-percent declining balance, or any other method. (For an example showing this, see Table 2.) Thus, the required switch from 200- to 150-percent declining balance plays no role in achieving equivalency with expensing. It does unfortunately have the effect depriving small and growing firms of precious cash flow. Since the adjustment serves no useful purpose, it can only be concluded that it was included in NCRS to allow a small immediate acceleration of cash flow to the government so that this enormous tax reduction can be official scored as a tax increase.

Expensing is the ultimate in accelerated depreciation. It provides an up-front deduction which by itself has a present value large enough to shelter all the income from property placed into service. Thus, solely as a result of expensing, the property has an effective tax rate of zero. If the property is to any extent financed with debt, additional deductions in the form of interest are available to shelter other income. Thus, when a debt-financed property is expensed, the property's asset's effective tax rate is negative. In part because tangible capital serves as good collateral for lenders, most investment in plant and equipment is routinely financed by debt to at least some degree. Thus, NCRS goes beyond tax relief and provides a *subsidy* for most business investment in new equipment.

As noted above, negative effective tax rates mean that new assets will generate more deductions than income. Under NCRS, many capital intensive and highly leveraged firms will be able to completely eliminate their corporate income tax liability even though their financial statements report that they are profitable. The minimum tax does not prevent this because NCRS depreciation methods will also be used for the alternative minimum tax.

Inflation adjustment for longer lived property under NCRS is a substantial benefit relative to current law. However, the benefits provided under NCRS to long-lived property are not as generous as it is to those received by short-lived property that is subject to a full cost recovery adjustment. Given this major disparity in treatment between equipment and structures, this "neutral" system is markedly non-neutral. In particular, because of the high concentration of equipment investment in manufacturing, it is generally the case that manufacturing will be advantaged over other sectors of the economy.

2. *Tax Shelters and Tax-Motivated Leasing*

In addition to the NCRS bias in favor of equipment over structures, there are several other inefficient distortions to economic behavior induced by NCRS. When tax rates fall below zero as they do under NCRS, new assets will generate more deductions than income. These excess deductions can be used to shelter income from sources other than new capital. Sheltering transactions can take a variety of forms. None of them are particularly attractive from a policy perspective in that they usually involve a distortion in the allocation of capital or businesses engaging in transactions that are purely tax-motivated.

Businesses generating excess deductions from depreciation of their new NCRS capital will first use these excess deductions to shelter the income generated by their pre-NCRS capital. New and growing firms generally will have relatively little pre-NCRS capital income. Therefore, new and growing firms unable to utilize the all of their generous NCRS deductions will be at a tax disadvantage relative to established firms.

Over time, more and more firms will be able to eliminate their entire tax liability as a result of NCRS. The number of tax-free businesses will grow because the proportion of total capital depreciated under NCRS will grow and because NCRS deductions will be backloaded. Once businesses are no longer subject to tax but continue to generate deductions, they are likely to engage in a wide variety of tax motivated transactions to get some value from their unused NCRS deductions.

NCRS will clearly provide large tax incentives for mergers and acquisitions. This is the granddaddy of sheltering transactions. In a typical case, a capital-intensive firm that is generating deductions in excess of income can put these deductions to work by merging with a profitable labor-intensive firm. Because NCRS's deductions are heavily backloaded, capital intensive firms that are not already in a tax loss position will have several years to seek out the right partner.

Were it not for enactment of passive loss limitation as part of the Tax Reform Act of 1986, much of the sheltering activity resulting from NCRS would probably involve partnerships of individuals investing in leveraged and tax-advantaged capital. These partnerships would generate tax losses that could be used to shelter other sources of individuals' taxable income. Although partnership tax shelter activity on the scale like that before the 1986 Act is not possible with the passive loss rules currently in place, there is no doubt that the enormous increase in the supply of marketable tax deductions wrought by NCRS will increase pressure on the current passive loss rules.

With individuals largely prevented by the passive loss rules from wholesale participation in the tax shelter market, tax shelter activity will shift to the corporate level. On the corporate side, large numbers of capital-intensive firms will have no tax liability and soon will be accumulating tax losses. In order to convert these otherwise unusable tax deductions into current benefit, tax-free firms will engage in leasing transaction with firms that have taxable income. The taxable firms will purchase assets and lease them to tax-free firms. The taxable lessor firms will pass some of the tax benefits through to the tax-free lessees through reductions in the lease rate, and will keep for themselves whatever is left after the lawyers and accountants get their share. These transactions will have little or no economic substance beyond those motivated by taxation.

3. *Complexity*

If enacted, NCRS would impose unduly complex tax rules on U.S. businesses. Sometimes complexity in the Code is unavoidable, but this is not the case here. What is so disappointing about NCRS is that there are many other ways to provide American businesses with the same tax benefits more simply and more efficiently. For example, the same economic benefits could be provided by expensing. Under NCRS, businesses would instead be required to recovery their capital cost over many years and these annual allowances would be subject to adjustments. Short-lived property would require a different set of adjustments than long-lived property. Moreover, for each class of property, in order to accurately index depreciation allowances, NCRS requires taxpayers to keep separate accounts for investments made in each quarter, instead of each year, as is now allowed under current law.

Although I do no not know who is responsible for the design of NCRS, it has "Made in Washington" stamped all over it. Clearly, this Rube Goldberg of tax breaks was not conceived on the Main Streets of America. Business men and women who have to deal with these tax rules will privately tell you that they would much prefer relief from the AMT, or extension of R&E credit, or expensing, or a simple lowering of tax rates.

4. *Shortfalls in Official Scorekeeping and Maintaining Confidence in Financial Markets*

NCRS would provide the most generous system of capital recovery every enacted into Federal tax law. It is entirely possible, however, for it to be scored officially as *raising* revenue. You do not need a Ph.D. economics to know their is something fishy about this, and the point will not be lost on financial markets trying to assess the seriousness of deficit reduction efforts in Congress.

It is possible for NCRS to be scored as a tax increase because of two serious shortcomings in the accounting for revenue effects of legislative changes. First, current accounting only measures changes in cash flows and not real economic costs. Second, official scorekeeping has a limited horizon that until recently did not extend beyond five or six years into the future. (The Senate has now begun to use ten-year horizons to evaluate revenue changes.)

What is particularly troubling about NCRS from the perspective of financial soundness is that NCRS appears to have been specifically designed to take advantage of these shortcomings. For example, as noted above, the combination of indexing allowances of short-lived property for the cumulative amount of inflation and real returns achieves the economic equivalent of expensing. Given these adjustment factors, the required change from 200-percent to 150-percent declining balance depreciation has no substantial economic effect (for example, the after-tax cost of capital would not be affected) except to give the appearance under current rules that this proposal is a revenue raiser.

In its estimate of an earlier (more generous) version of NCRS, the Treasury Department estimated that under official accounting methods NCRS would *raise* approximately $18 billion in revenue over fiscal years 1995-2000. For purposes of preparing for this testimony, I constructed my own revenue estimating model. In my model NCRS as described in H.R. 9 would raise perhaps $3 billion over fiscal years 1995-2000.

In addition the Treasury Department also provided estimates Treasury estimated total costs at $120 billion over fiscal years 1995-2005. My model estimates total costs over fiscal years 1995-2005 to be approximately $160 billion. Thus, like the Treasury Department's estimates, my model shows that the cash flow costs of NCRS are heavily backloaded.

But even these long-term cash flow changes do not accurately portray the real cost of NCRS. In order to allow the Committee to better assess the real costs of this proposal, I also used my estimating model to calculate the cost of the investment tax credit that would be economically equivalent to NCRS. I believe this is the best measure of the true cost of NCRS because when an asset is placed in service it will be irrevocably entitled to a stream of additional tax deductions (because the chance of retroactive tax increases are close to nil). The real cost to government--and the real benefit to the taxpayer--is the change in the present value of those deductions multiplied by rate of tax, and this is exactly how the equivalent investment tax credit is calculated. These rates of credit vary depending upon the useful life the asset and are shown at the end of this testimony (Table 3).

When I estimate the revenue costs of investment tax credits economically equivalent to NCRS, the impact on Federal finances over the 1995-2000 fiscal year changed from *positive* $3 billion under cash flow conventional accounting changed to *negative* $160 billion. Over the 1995-2005 budget window, the impact changed from negative $167 billion to negative $370 billion.

It is this type of discrepancy between the official cost estimates and real economic costs that will spook financial markets. If the 1995-2000 budget window is used and NCRS is officially scored as revenue neutral or even a small revenue raiser when its real costs for that period are $160 billion, and that $160 billion loss to government is not matched by a real spending cuts or tax increases of a similar magnitude, long term interest rate will rise as financial markets anticipate the demand for increased federal borrowing in the future to make up this shortfall. Moreover, unless foreigners invest more heavily in the United States, increased government demand for funds will likely crowd out private investment and frustrate the objective of NCRS.

Besides this large and direct impact on the supply and demand for financial capital, there is an additional negative impact of this gimmickry embodied in NCRS. A backdoor increase in the Federal deficit is more detrimental to market confidence than are increases in the deficit that are plain for all to see. This is because use of gimmicks sends a troubling signal that the Federal government is not really serious about reducing the deficit. It tells the market that when the going gets tough, the government will resort to more gimmicks. If the Federal government cannot be square with the American people and soundly finance the Contract with America, how sincere can be its efforts to eliminate the deficit by 2002?

Conclusion

The objective of NCRS is to promote economic growth with tax incentives for investment. However, much of the benefit of lower taxes on capital will be offset by higher interest rates and reduced availability of funds if the costs of NCRS are not honestly accounted and paid for. Under NCRS many profitable corporations would no longer pay corporate tax and owners of many noncorporate businesses would pay no income tax at all. As these tax-free businesses generated more losses, tax-free businesses would have large incentives to merge with taxable businesses or to sell their tax benefits to taxable businesses. Finally, NCRS's attractiveness to business is substantially curtailed by its complexity and its negative impact on cash flow.

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Table 1. Comparison of Current Law and NCRS Depreciation

CURRENT LAW: 5 -YEAR LIFE, DOUBLE DECLINING BALANCE, HALF-YEAR CONVENTION

YEAR		1	2	3	4	5	6
DEPRECIATION @200%		20.00	32.00	19.20	11.52	11.52	5.76
NOTE:							
TOTAL ALLOWANCES	100.00						
PRESENT VALUE @ 8%	$87.62						

NEUTRAL COST RECOVERY SYSTEM: 5-YEAR LIFE, 150 PERCENT DECLINING BALANCE, HALF-YEAR CONVENTION, ADDING ADJUSTMENTS FOR INFLATION AND EXPENSING

YEAR		1	2	3	4	5	6
DEPRECIATION @150%		15.00	25.50	17.85	16.66	16.66	8.33
INFLATION ADJUSTMENT FACTOR		1.000	1.050	1.103	1.158	1.216	1.276
'EXPENSING' ADJUSTMENT FACTOR		1.000	1.035	1.071	1.109	1.148	1.188
NEW DEPRECIATION		15.00	27.71	21.08	21.38	23.24	12.63
NOTE:							
TOTAL ALLOWANCES	121.04						
PRESENT VALUE @ 8%	$101.38						
NOTE:							
REVENUE EFFECT OF CHANGE TO NCRS WITH 35% RATE		1.75	1.50	-0.66	-3.45	-4.10	-2.40

Table 2. A Comparison of the 150- and 200-Percent Declining Balance Methods–NCRS Adjustments Achieve Equivalent Present Value of Deductions Irrespective of the Depreciation Method Used

150 PERCENT DECLINING BALANCE

YEAR	1	2	3	4	5	6
DEPRECIATION @150%	15.00	25.50	17.85	16.66	16.66	8.33
INFLATION ADJUSTMENT FACTOR	1.000	1.050	1.103	1.158	1.216	1.276
'EXPENSING' ADJUSTMENT FACTOR	1.000	1.035	1.071	1.109	1.148	1.188
NCRS DEPRECIATION	15.00	27.71	21.08	21.38	23.24	12.63

NOTE:

TOTAL ALLOWANCES	121.04
PRESENT VALUE @ 8%	$101.38

200 PERCENT DECLINING BALANCE

YEAR	1	2	3	4	5	6
DEPRECIATION @200%	20.00	32.00	19.20	11.52	11.52	5.76
INFLATION ADJUSTMENT FACTOR	1.000	1.050	1.103	1.158	1.216	1.276
'EXPENSING' ADJUSTMENT FACTOR	1.000	1.035	1.071	1.109	1.148	1.188
NCRS DEPRECIATION	20.00	34.78	22.68	14.79	16.07	8.73

NOTE:

TOTAL ALLOWANCES	117.04
PRESENT VALUE @ 8%	$101.13

Note: Present values do not equal $100 because mechanics of statutory draft only approximate the formula necessary to achieve expensing equivalence. To achieve equivalence, the capital recovery adjustment should equal $(1+r+p)^n$ where r is the real rate of interest, p is the rate of inflation, and n is the number of years since the property was placed in service. The statutory draft uses an adjustment equal to $(1+r)^n*(1+p)^n$. This creates a bias for the cost recovery adjustment to be larger than that necessary to provide the equivalent of expensing.

* * * * * *

Table 3. Rates of Investment Tax Credit Providing Equivalent Tax Benefits to those Provided Under NCRS

Class Life	ITC Rate
3 years	2.70%
5 years	4.82%
7 years	6.73%
10 years	9.32%
15 years	7.18%
20 years	8.28%
27.5 years	9.81%
39 years	10.61%

Ms. DUNN. Thank you very much, Dr. Sullivan.

We will move to questioning now, and Mr. Collins will inquire.

Mr. COLLINS. Thank you, Madam Chairman.

Mr. Sullivan, I gather from your testimony that the NCRS is not your ideal way of improving capital costs for recovery, and I think that is putting it mildly. What do you think of the suggestion of improving the alternative minimum tax that others have already made?

Mr. SULLIVAN. There really is no economic basis for an alternative minimum tax from an economic perspective. Reducing the alternative minimum tax, if honestly paid for, is a much preferable way of providing capital tax breaks.

Mr. COLLINS. Thank you, that is all I have, Madam Chairman.

Ms. DUNN. Mr. Rangel will inquire.

Mr. RANGEL. Thank you.

Dr. Sullivan, we are going to have to assume that the Contract With America had economists working on it just as smart as you. You and the Treasury seem to believe that this is a tremendous budget buster; $150 billion loss. All of us support a balanced budget. Certainly, scoring is very, very important in our business, because there will be devastating cuts unless we can find the right numbers.

Now, why as an economist, would you believe that anyone for political reasons would want to cook the books to come up with these types of numbers when they, too, are dedicated to providing services and balancing the budget?

Mr. SULLIVAN. Well, I am only an economist, I can't speak to motivations.

Mr. RANGEL. Well, let me rephrase the question. Economists that support different figures forgetting political motivation, how do they justify it?

Mr. SULLIVAN. The one thing that has not been part of this discussion today that is critically important when we are talking about the economic impact of NCRS, is whether it is going to be paid for or not.

Mr. RANGEL. Dr. Sullivan, that is a part of the Contract. It has got to be paid for. As a matter of fact, it has to be paid for before we mark up the bill. But you don't know what to pay unless you know what the cost is.

And it seems to be a tremendous difference of opinion between people, such as yourself, and the U.S. Treasury Department, and those people that have been used to give estimates to those who put together the Contract. So, forget the cost—nobody with the Contract is indicating that they want the tax relief and not pay for it. That is universal.

Now, my question is, why would they come up with such different figures? And you have to assume good intent for purposes of my question. They are professional people.

Mr. SULLIVAN. I do not believe the figures that I have drawn up are controversial. I think it is very clear to everybody that this is a tremendous drain on the U.S. Treasury. With all due respect to the diverse opinions, I think this is a fact.

The real problem with NCRS is not even within the code sections that describe it. If it is not financed, if it is not paid for in a meaningful way, and there is an end run around the budget rules, NCRS will have a very detrimental impact on the financial markets.

Mr. RANGEL. I know that there are various opinions about this recovery program on the panel, but does anyone challenge his analysis of the cost?

Mr. MCCALLUM. Mr. Rangel, I would make a comment, and I would try to segregate, for a moment, the difference between this proposal trying to get us to a competitive depreciation system with the rest of the world and financing that system. I think you are talking about financing that system, and I think we are saying that it should be paid for and that is, in your judgment, all of you, to make sure that that happens and that it is done correctly.

Mr. RANGEL. I will accept that challenge. But you have to tell me what it costs so I would know how to pay for it. And if you are talking about something that is so—so expensive, we just have to weigh how fast we move to competition.

Most Members of Congress agree with the testimony that we have to catch up with the other countries. But politically, we agree that we cannot cause an increase in our deficit and a failure of people to rely on our economy. And when these numbers come like they are, and there is a dramatic difference of opinion, assuming good faith, we have to rely on people such as yourself to help us to make these decisions.

So, this panel will leave the question regarding this tremendously expensive tax provision.

Thank you, Madam Chairlady.

Ms. DUNN. The gentleman's time has expired.

The questioning will be continued by Mr. English.

Mr. ENGLISH. Thank you, Madam Chairman.

Dr. Sullivan, we heard an earlier panel discuss the concern of Secretary Samuels expressed earlier this week that the NCRS system creates the possibility of some new tax shelters. I judge from your testimony, that you share that concern?

Mr. SULLIVAN. Yes, I do, Mr. English.

Mr. ENGLISH. Could you talk a little bit about the specifics briefly.

Mr. SULLIVAN. The 1986 act, with passive loss limitation rules, eliminated what we call the dentist in New Jersey-type of tax shelter where individuals are able to join partnerships and eliminate tax on their unrelated income. That will not occur under NCRS.

However, because you have all of these losses in the economy, 10 and 20 and 30 billion dollars' worth of losses without any income, businesses, because they are innovative, will try to engage in transactions to shelter that income.

There are two primary forms of sheltering that will occur: Leasing, mergers, and acquisitions. The economic forces will just be too strong for anybody to resist.

Mr. ENGLISH. I would like to explore kind of without polemics, the question of the difference between your revenue numbers and those from the Treasury. Is there any methodological difference between your models?

Mr. SULLIVAN. I don't believe so. My model is a much cruder model than the Treasury's model. But I used the same basic methodology. I would not have even brought it before the committee if I did not think it would be generally accepted as accurate.

But my second set of figures, the larger set of figures, is different from Treasury's. It is methodologically different from the Treasury's and different from any official estimate, because I try to measure the real costs and not just cash flows.

Mr. ENGLISH. Let me shift gears a second. You commented on the efficacy of addressing the AMT problem and that impacts on certain classes of industries. My own view is that we also need broader relief for capital investments throughout the economy.

And I wonder if you would comment on the provision raising the small business equipment expensing threshold from $17,500 to $25,000. I wonder, particularly for small dynamic manufacturers like I have in my district, would raising that threshold further to, say, $100,000 have a benefit, and from an economics standpoint, how would you analyze that kind of a tax change?

Mr. SULLIVAN. Raising the expensing limitation under 179 would certainly be a superior change in the law relative to this provision. It is simpler. It achieves the same economic effects, but in particular, for small businesses, it provides much more cash flow, which is critical for them. Unfortunately, under current scoring rules, that type of change is unduly penalized because the cash flows are frontloaded and we only measure the cash flow costs.

Mr. ENGLISH. Thank you.

Mr. Beghini, welcome.

In your testimony, you discuss some of the problems associated with the AMT, and I was wondering what specific changes could be made to the AMT that would help your industry?

Mr. BEGHINI. Well, one of the first changes that was mentioned by the first panel would be to conform the AMT depreciation rate to the regular tax depreciation rate. In addition, we believe that AMT tax credits should be applicable against future AMT liability.

We would like to see the IDC, the intangible drilling costs, preference item repealed. We would like to exclude environmental-related assets from AMT depreciation. We would like to see the 90-percent foreign tax credit limitation removed. And we would like to repeal the LIFO adjustment, which in our industry is a very, very large adjustment when we get price spikes.

Ms. DUNN. The gentleman's time has expired.

Mr. ENGLISH. Let me just say, I appreciate Mr. Powell being here. I wish I had had an opportunity to question him. Air products has been a good neighbor in the Allegheny Valley just outside of my district.

Ms. DUNN. A vote is appearing on the floor within 5 or 10 minutes, so I ask that questioners and responders be brief.

Mr. Christensen will inquire.

Mr. CHRISTENSEN. Dr. Sullivan, I usually pick on people who I don't agree with, but I like you because you are self-employed and I appreciate you coming here and I respect your opinion. I appreciate the fact that your viewpoints here were very well thought out. I am not sure that I agree with them all, but I do respect the fact that you are a self-employed economic forecaster.

I wanted to ask Mr. Powell if there were any other tax ramifications that were affecting the Chemical Manufacturers Association that we could take a look at on this committee that would help you and your association? Is there anything facing your particular industry, similar to Mr. Beghini, or is it all the same?

Mr. POWELL. Well, I must say, I haven't thought about that recently and I am sure if I had some time, we could come up with items that are truly troublesome. But I think capital recovery in the chemical industry is very important, we are the largest exporter of the United States and we are faced with competition. If we want to produce in the United States, we need capital recovery. And I would say that elimination of the AMT would be a strong first step for us.

Mr. CHRISTENSEN. Thank you, Madam Chairman.

Ms. DUNN. Thank you.

Mr. Payne.

Mr. PAYNE. Thank you very much, Madam Chair.

I had one point of clarification for Dr. Sullivan. Did I understand you to say that there would be two kinds of tax shelters that would be created by the neutral cost recovery provision, leasing and mergers and acquisition? I understand the leasing part. Could you explain why mergers and acquisitions might become a tax shelter product or industry under this provision?

Mr. SULLIVAN. Certainly, I would be glad to. A capital-intensive business—eventually, and this becomes increasingly the case over time because of all the benefits that are backloaded—will zero out, that is, pay no income tax. Also, the minimum tax liability will not be a factor because NCRS also applies to the minimum tax. These capital-intensive corporations will have large amounts of unused tax deductions.

The only way for them to use their NCRS deductions if they don't go the leasing route, would be to merge with a profitable firm, which would typically be a labor-intensive, service-sector firm, with a steady flow of profits. This profitable firm would be able to shelter its income against those unused losses generated by capital-intensive firms.

Mr. PAYNE. And that really becomes a situation that would occur, as I have looked at these schedules, perhaps in 6, 7, 8, 9, 10 years? It is a problem that is down the road?

Mr. SULLIVAN. Yes, one big difference between expensing, which is up front, and NCRS, which is very backloaded is that you will see it coming. The corporate treasurers will see it coming and they will be able to create a lot of value by corporate marriages with good suitors who have a tax situation which is compatible to creating this value. So they will have time. And it will occur starting 4, 5, 6 years out. That is when the big wave would occur.

Mr. PAYNE. Wouldn't expensing provisions have the same potential impact?

Mr. SULLIVAN. Expensing will have the same impact, but because the cash flow effects are up front, it will happen much more quickly.

Mr. PAYNE. So you are saying that more expensing could lead to more tax shelters more quickly, as a result of mergers and acquisitions?

Mr. SULLIVAN. Yes, I would say that relative to NCRS, expensing on a broad scale would also have incentives for mergers and acquisition, and that is more likely to occur earlier rather than later in time.

Mr. PAYNE. As I say, this is only a point of clarification because I am in favor of expensing. This committee passed a provision more generous than the $17,000 which was enacted, in fact, it was $25,000 as it came out of this committee last session. That is something that I hope we will revisit, which is why I was interested in knowing your thoughts on it.

Mr. SULLIVAN. $17,000 to $25,000 is on such a small scale that I don't think that would result in a merger and acquisition problem.

Mr. PAYNE. Thank you very much.

Ms. DUNN. Thank you, Mr. Chairman.

Questioning will resume with Mr. Herger.

Mr. HERGER. Madam Chair, I will yield to Mr. Collins.

Ms. DUNN. Thank you.

Mr. Collins.

Mr. COLLINS. Thank you, I appreciate the gentleman yielding.

The comment was made I believe it was Mr. McCallum, pointed out that what we have to weigh here is a decision between cost and competition. Was not that a fair statement?

And you agreed with that, Dr. Sullivan. That seems to be a simple decision to weigh. However, due to the laws and the regulations that we have to operate under, it does throw a roadblock in our way because we have to deal with the cost.

But my point is, and I have said this all along, that I think the biggest competitor or the stiffest competition to American business and American jobs, is the Congress. It is the U.S. Government. And if a corporation who is in global competition is facing a tax policy that prohibits them from being competitive, is that not an incentive to move that business offshore to where they can become competitive?

Mr. MCCALLUM. Mr. Collins, I agree with what you are saying. If we look at our depreciation system, it really is a tool for business to compete. And if we don't have as good a tool as other nations around the world, then we will ultimately lose that competition.

Now, the issue of being able to pay for this system, if the facts are that we cannot afford that today, that does not take away from the fact that we are failing to provide American business competitive tools. And if the issue is one of trying to pay for this, and we can't do it today, then certainly I know this committee, many members on this committee, have talked about the alternative tax systems that exist around the world that favor savings and investment and focus more on taxing consumption.

And I know that Chairman Archer and members of both sides of the aisle have talked about taking up that discussion later this year. And those types of systems may ultimately have to be the long-term solution to this problem if we can't deal with it here today.

Mr. COLLINS. The question is, though, is that tax policy, the existing tax policy itself, for a business who is noncompetitive in the global market, that tax policy then if they can move to a competitive area is an incentive to relocate; one incentive.

Mr. McCALLUM. It is certainly one element that would be an incentive to move elsewhere, especially if you were a very capital-intensive industry where your capital investment is keyed to that pricing decision for you and your ability to compete.

Mr. COLLINS. Thank you.

Ms. DUNN. Thank you very much panel. We appreciate the brevity of the panel and the members.

We will recess for the duration of the vote, and I urge members to return as quickly as possible.

And we will seat the third panel.

Thank you.

[Recess.]

Mr. HERGER [presiding]. The Ways and Means Committee will reconvene, and if our third panel could please step forward.

Gary Kachadurian, secretary, member of the executive committee of the board of directors of the National Multi Housing Council, and also on behalf of the National Apartment Association and principal, RREEF Funds, Chicago, Ill.; also Edmund G. "Gill" Woods, president, National Association of Realtors and president, Edmund G. Woods Co., Holyoke, Mass.; James J. Didion, chairman, National Realty Committee, chairman and chief executive officer of CB Commercial Real Estate Group, Los Angeles, Calif.; and Kemper Freeman, Jr., president, International Council of Shopping Centers and president, Kemper Development Co., Bellevue, Wash.; and Calvin Johnson, professor of law at the University of Texas, Austin, Tex.

I thank our panelists.

And Mr. Kachadurian, if you would proceed, please. We do have 5 minutes and your statements—your printed statements will be, without objection, submitted for the record.

Mr. Kachadurian.

STATEMENT OF GARY T. KACHADURIAN, PRINCIPAL, RREEF FUNDS, CHICAGO, ILL., AND SECRETARY AND MEMBER OF THE EXECUTIVE COMMITTEE OF THE BOARD OF DIRECTORS, NATIONAL MULTI HOUSING COUNCIL, AND ALSO ON BEHALF OF THE NATIONAL APARTMENT ASSOCIATION

Mr. KACHADURIAN. Thank you, Mr. Chairman and members of the committee.

Thank you for this opportunity to appear before you today to discuss the issue of capital gains. My name is Gary Kachadurian. I am a principal of the RREEF Funds of Chicago, Ill., and serve as secretary and member of the executive committee of the board of directors of the National Multi Housing Council.

Through our legislative joint program with the National Apartment Association, we represent the majority of the Nation's firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of development and operation of multifamily rental housing, including ownership, construction, development, financing and management.

There are approximately 15 million multifamily units defined as a complex of five or more units in the United States. In normal economic times, rental housing is the fifth largest contributor to the U.S. economy.

The National Multi Housing Council and National Apartment Association are dedicated to providing clean, safe, affordable living for millions of Americans. Because our industry is so competitive, Federal and State tax policies have a direct and substantial impact on the livability as well as rent levels that are enjoyed by occupants.

Mr. Chairman, the National Multi Housing Council and National Apartment Association strongly support the capital gains provisions included in H.R. 9. We want to commend the foresight shown in this legislation that reduces capital gains rates, brings the concept of indexing for inflation and rejects onerous depreciation recapture provisions.

Real estate is emerging from one of the worst periods in its history. After several years of a severe economic period for real estate and many foreclosures, only recently have we begun to see the cost and availability of credit for purchase or development of multifamily housing return to somewhat normal conditions.

Any broad-based capital gains legislation that omits real estate will cause a tremendous amount of disintermediation in the capital markets as money flows away from real estate into those investments that benefit from a reduction in the tax. This will lead to fewer Federal income and payroll taxes being collected from real estate companies and their workers, foreclosures, pressure on the banking and financial system, a reduction in property values and finally a reduction in tax revenues to State and local governments who rely on property taxes for a majority of the money they receive to fund school systems, fire departments, police departments, and other services. Any reduction in capital gains rates must include real estate.

In 1992, President Bush proposed a reduction in the capital gains rate. Unfortunately, he coupled this reduction with an onerous provision that required full recapture of all previously taken depreciation at ordinary income rates. A meaningful reduction in the capital gains rate that does not include an onerous depreciation recapture provision, will lead to new investment in tens of thousands of existing apartment units across America whose present owners have no financial incentive to invest in needed capital improvements.

This new investment is badly needed and will result in the creation of many jobs for carpenters, painters, electricians, plumbers, appliance makers and others. Little, if any, of this new investment will occur under the present capital gains rate of 28 percent because of something referred to as the exit tax.

The provisions of H.R. 9 aid in solving the exit tax problem for properties that have substantial negative capital accounts by their partners. Under current law, most dispositions of older properties would result in huge gains on paper for tax purposes without enough actual cash from the sale to pay the taxes.

At present, existing partners are unable to sell these properties for a sufficient amount of cash to pay the taxes that would be due. Therefore, these investments will remain frozen for many years.

There will be a very positive revenue effect accruing to the U.S. Treasury from the unlocking of investments in more than 1 million apartment units.

Just a few weeks ago Speaker Gingrich asked you to challenge members of the corporate community regarding creation of high-paying jobs in the United States. Speaking for the multifamily housing industry, we believe that a significant reduction in the capital gains tax will result in thousands of new high-paying jobs for modernization of more than 1 million apartment units here in America.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF GARY T. KACHADURIAN
NATIONAL MULTI HOUSING COUNCIL

Mr. Chairman and Members of the Committee, I thank you for this opportunity to appear before you today to discuss the issue of capital gains. My name is Gary Kachadurian. I am a Principal of RREEF Funds of Chicago, Illinois and serve as Secretary and a member of the Executive Committee of the Board of Directors of the National Multi Housing Council. Through our legislative joint program with the National Apartment Association, we represent the preponderance of the nation's firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the development and operation of multifamily housing, including ownership, construction, finance, and management of rental properties.

There are approximately 15 million multifamily units, defined as part of a complex of five or more units, in the United States. A study by Regis J. Sheehan & Associates for the U.S. Departments of Labor, Commerce, and HUD showed that in 1993 "the rental housing industry's contribution to the Gross Domestic Product was about $153.2 billion dollars representing 2.3% of our economy." In normal economic times, rental housing is the fifth largest contributor to the United States economy.

The National Multi Housing Council and National Apartment Association are dedicated to providing clean, safe, affordable living for millions of Americans. Because our industry is so competitive (just look at any metropolitan apartment guide), federal and state tax policies have a direct and substantial impact on the liveability as well as rent levels that are enjoyed by occupants.

SUPPORT FOR REDUCTION IN THE CAPITAL GAINS TAX

Mr. Chairman, the National Multi Housing Council and National Apartment Association commend you for sponsoring H.R. 9, the Job Creation and Wage Enhancement Act of 1995 and we strongly support provisions in Title I of this legislation that would reduce the current capital gains tax rate and index the adjusted basis of assets for inflation beginning in 1995. We believe that a reduction in the capital gains rate will actually bring in more money to the U.S. Treasury as real estate capital assets are unlocked by existing investors and new money is brought in for investment and modernization by new investors.

REAL ESTATE MUST BE INCLUDED

Real estate is emerging from one of its worst periods in history. After several years of a severe economic period for real estate and many foreclosures, only recently have we begun to see the cost and availability of credit for purchase or development of multifamily housing return to somewhat normal conditions. Even today, credit for the construction and modernization of multifamily housing is not as broad as for many other areas of investment.

Any broad-based capital gains legislation that omits real estate will cause a tremendous amount of disintermediation in the capital markets as money flows away from real estate and to those investments that benefit from a reduction in the tax. The resulting scarcity of credit for real estate will drive our industry into another extraordinarily difficult period. This in turn will lead to fewer federal income and payroll taxes being collected from real estate companies and their workers, foreclosures, pressure on the banking and financial system, a reduction in property values, and finally a reduction in tax revenues to state and local governments who rely on property taxes for a majority of the money they receive to fund school systems, police and fire departments, and other essential services.

Any reduction in capital gains rates must include real estate.

THE DEPRECIATION RECAPTURE ISSUE

In 1992, President Bush proposed a reduction in the capital gains rate. Unfortunately, he coupled this reduction with an onerous provision that required full recapture of all previously taken depreciation at ordinary income rates. The theory was that since the basis of a real estate asset had been reduced by depreciation which taxpayers had deducted from their ordinary income, recapture was necessary in order to be "fair" when lowering the capital gains rate. In practice, nothing could be further from the truth.

There is nothing wrong with depreciation recapture as long as it does not affect the economic rate of depreciation that has been taken in the past. The fact is that real estate is subject to economic depreciation, especially in the case of multifamily housing.

In addition, recapture would be both punitive and confiscatory vis-a-vis other investments. For example, if I invest in the stock of a manufacturing company, I benefit from the cash flow that company is able to attain as a result of good operations and depreciation deductions. When I sell that stock, I am not assigned a pro rata portion of the depreciation that the company took to enhance its overall cash flow. Likewise, taxpayers should not have to incur an onerous provision for recapture of depreciation on real estate investments at ordinary income levels. Real estate assets do depreciate at an economic rate and recapture is not necessary to bring "fairness" to a reduction in the capital gains rate.

If an onerous recapture requirement is included in any capital gains reduction, then real estate will experience the same capital disintermediation I outlined above. The net result of the 1992 proposal, which would have lowered capital gains tax rates but required full depreciation recapture, was to actually bring in more revenue from real estate under static revenue scoring. The reason? The recapture provision resulted in a confiscatory tax and the likely result was that real estate assets would continue to be "frozen" in existing investor accounts. Much needed new capital investment would not occur and, in fact, capital markets would once again shun real estate credit advancement.

Mr. Chairman, we applaud you for not including a depreciation recapture provision in H.R. 9.

A LOWERING OF THE CAPITAL GAINS TAX WILL BRING IN MUCH NEEDED FUNDS FOR MODERNIZATION OF TENS OF THOUSANDS OF APARTMENT UNITS

A meaningful reduction in the capital gains rate that does not include onerous depreciation recapture provisions will lead to new investment in tens of thousands of existing apartment units across America whose present owners have no financial incentive to invest in needed capital improvements. This new investment is badly needed and will result in the creation of many new jobs for carpenters, painters, electricians, plumbers, appliance makers, and others.

For example, Drever Partners of San Francisco, California has acquired over 18,000 units during the past 7-1/2 years with investment groups comprised primarily of tax-exempt investors. The capital improvements have averaged $4,000 per unit, or a total of more than $72 million for improvements alone. A reduction in the capital gains rate would attract similar private investors willing to make the improvements necessary for capital appreciation.

As just one example, I know of a major apartment owner in New Jersey who would pour in $1.5 million into modernization of a building that would cost $23 million.

Mr. Chairman and Members of the Committee, this type of anecdotal evidence does not even scratch the surface. In the case of apartments, a meaningful lowering of the capital gains tax rate would result in thousands of new, good paying jobs here in America.

THE "EXIT TAX" PROBLEM

Little, if any, of this new investment will occur under the present capital gains rate of 28% because of something referred to as the "exit tax." The provisions in H.R. 9 aid in solving the exit tax problem for properties that have substantial negative capital accounts by their partners. Under current law, most dispositions of older properties would result in huge gains on paper for tax purposes without enough actual cash from the sale to pay the taxes. At present, existing partners are unable to sell these properties for a sufficient amount of cash to pay the taxes that would be due. Therefore, these investments will remain frozen for many years with no incentive for existing owners to put in capital to preserve and modernize the units for tenants. This problem will become even more critical considering the millions of units that will be affected as HUD Section 8 contracts expire over the next few years.

Some estimate that a more likely figure of $7,000 to $10,000 per unit would be invested by new partners in the modernization of existing apartment units. There are estimates that more than one million units are in need of capital improvements, but existing owners do not have the financial incentive to spend the money.

Mr. Chairman and Members of the Committee, just a few weeks ago Speaker Gingrich asked you to challenge members of the corporate community regarding creation of high paying jobs in the United States. Speaking for the multifamily housing industry, we believe that a significant reduction in the capital gains tax will result in thousands of new high-paying jobs for modernization of more than one million apartment units here in America. To accomplish this, the Committee may have to look at bringing negative basis in apartment investments to zero when applying the new capital gains rates.

The U.S. Treasury stands to receive a large increase in revenues from capital gains taxed at a significantly lower rate. You have heard this before and it is true: the great reservoir of fixed investments that are "locked" for many years to come would, in short order, be freed and new money brought in that is vitally needed. In the case of multifamily housing, thousands of new jobs would be created as new investors spend money to modernize existing apartment units. Modernized apartments will enhance both federal and state and local taxes and greatly improve living conditions and neighborhoods.

CONCLUSION

The National Multi Housing Council and the National Apartment Association strongly support the capital gains provisions included in H.R. 9. We want to commend the foresight shown in this legislation that reduces capital gains rates, brings in the concept of indexing for inflation, and rejects onerous depreciation recapture provisions.

Mr. HERGER [presiding]. Thank you for your testimony, Mr. Kachadurian.

Mr. Woods.

STATEMENT OF E.G. "GILL" WOODS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, AND PRESIDENT, EDMUND G. WOODS, INC., HOLYOKE, MASS.

Mr. WOODS. Good afternoon Mr. Chairman.

My name is Gill Woods. I am the president of the National Association of Realtors and Edmund G. Woods, Inc., and I am representing this afternoon 750,000 members of the National Association.

First, let me thank the committee for inviting me here to speak. And I certainly would like to commend Chairman Archer and his cosponsors for drafting a thoughtful and meaningful bill dealing with capital gains.

Ever since the enactment in 1986 of the Tax Reform Act, the National Association of Realtors has worked for more equitable treatment for many small- and medium-sized investors that were trapped in the real estate that they couldn't afford to get rid of because of this bill.

Most, if not all, of these investors were not astute enough to bail out of their holdings in the late eighties when the major players were able to get out with fairly favorable capital gains treatments.

Now, there are thousands of small investors. Interestingly, 20 percent of all families in this country own real estate investment who have income between $25,000 and $50,000. We are not talking about people that are just worth tons of money, but many of these individuals are frozen into investments because of taxes. And what is most unfair is that these taxes by and large are based on inflation, not on real gains and property value.

And let me just give you a very quick example. If you purchased a four family house here in Washington 15 years ago and paid $100,000 for it, today, because of inflation and only because of inflation, let's say, 5 percent a year, compounded over 15 years, that property would have to sell for $200,000 just to get back your original investment without making one single dime of profit. But if I sold that piece of property or you sold it at that figure, you would owe State and Federal taxes close to $40,000, and that is even though you made no profit whatsoever.

And that is why I say so many of these small investors are frozen into their properties. The Contract With America goes a long way to solve this problem in the future by indexing future gains to inflation and helping present owners by reducing the capital gains rate of taxation by 50 percent. These two aspects alone would make this part of the Contract With America important to our members and millions of investors throughout the country. But there is certainly another aspect that will help thousands of families, especially in the hard-hit areas like New England and California, where real estate values have fallen precipitously, in some areas 40 to 50 percent.

And that is by allowing families that bought at the very, very top of the market in the early eighties, the mideighties to at least get some relief from their out-of-pocket capital losses when they sell their home at a loss. Under Chairman Archer's bill they would be allowed to deduct at least $3,000 per year from their income until that loss was used up.

Under the present tax law, if they are forced to sell a house at a loss for any reason, that is your tough luck. Many young families that I have seen, and I have done business with, have seen their entire savings wiped out just because of a forced job relocation they had no say in. At least these families will now have a chance to get part of their losses back over a period of time.

Let me change gears just for a moment and briefly discuss the American dream savings account. One of the provisions intended is to provide funds for a downpayment for first-time buyers. And I can tell you as a practicing real estate broker, the biggest obstacle to home ownership is not interest rates, but it is the cash it takes for downpayments and closing costs today. If you turn to the handout that you have right here and you look toward the back on charts A and B, you will see that there is a substantial dropoff in home ownership in the under-35-year-old age group. Studies have shown it is not because of lack of interest, it is not because of lack of income, but it is because of the inability to put together the downpayment that is required to purchase a home.

Because of the 5-year holding period in the American dream savings account, it will have almost no effect on home ownership until the year 2000, and that is just too far away. Believe me, there are thousands of young families out there that need assistance now. They don't need assistance 5 years from now, and is there a way to do it, too.

If funds from current IRAs and 401(k)s could be used without a tax penalty, then tens of thousands of young families could go out and purchase their first home now. And if we allow parents and grandparents to help out their children in the same manner as suggested by Congressman McCrery, we could double that figure of first-time home buyers using this method to purchase a home immediately.

Thank you very much.

[The prepared statement and attachments follow:]

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

JANUARY 26, 1995

INTRODUCTION

Mr. Chairman and Members of the Committee. My name is E. G. "Gill" Woods, the 1995 President of the National Association of Realtors®. I am also President of Edmund G. Woods, Inc., a residential real estate firm in Holyoke, Massachusetts. I appear here today on behalf of the 750,000 members of the National Association of Realtors® (NAR). The Association represents virtually every facet of the real estate industry, including REALTOR® brokers and salespersons, developers, counselors, appraisers and property managers. We wish to thank you for holding these hearings and for receiving our testimony on the Republican Contract with America, particularly those parts of H.R. 6 and H.R. 9 that deal with American Dream Savings Accounts, capital gains and the Neutral Cost Recovery System. Each of these provisions has the potential to benefit real estate markets nationwide.

Real estate contributes about 16% of the goods and services that comprise our national economy. The industry has repeatedly demonstrated its capacity to lead the nation out of recession into economic recovery and growth. The Contract with America presents a balanced real estate package with provisions that apply to both the residential and commercial sectors, and to owners, potential owners and investors. The Contract corrects some imbalances that exist in the present system and some inequities that arose from the reforms of the 80's, but it does not undermine the appropriate reforms that were enacted then. Thus, the package, when enacted, does not carry the potential for re-igniting the go-go market that lead to over building and see-through buildings.

While the tax battles of 1992 and 1993 were often divisive and partisan, the debate then concerning the real estate provisions was bipartisan and widely agreed upon. We are hopeful that the same bipartisan spirit can prevail in this debate so that important goals of enhancing savings and investment, and achieving a healthy real estate economy across the country can be reached.

Our message today may sound overly familiar to some long-time members of this Committee. Indeed, we have previously presented testimony on most of the real estate issues found in the Contract. The predictions we made in 1986 about the dramatic decline in the real estate market if Congress enacted its proposed real estate provisions all, unfortunately, came true. During the period 1989-1992, some locations around the country experienced as much as a 30 percent decline in value of real estate in their markets. Imagine the effect on local tax bases of that decline. Local governments were forced to cut back on schools, safety and basic services that all our citizens have come to expect in their daily lives. Imagine, too, the effect on the owners of those properties. Many of these owners are average Americans -- retirees, working people, owners of small commercial and residential properties who are affected in dramatic ways by the sharp fall in values.

Federal Reserve data show that fairly significant amounts of non-owner-occupied real estate are held by households in income groups below $50,000. These individuals are adversely affected when real estate values fall. Retirement incomes are reduced, improvements are delayed, and family savings plans are eroded. Thus, any decline in property values reaches well beyond the syndicators and the glass see-through towers built in the 80's.

We strongly believe the provisions of the Contract that we will discuss below will help stabilize real estate values and strengthen local tax bases and economies.

H.R. 6 AMERICAN DREAM SAVINGS ACCOUNT

H.R. 6 proposes a new type of Individual Retirement Account (IRA) known as an American Dream Saving Account (ADSA). The new ADSA is an effort to create a tax-deferred and/or tax-free savings vehicle from which individuals can draw in order to pay for the fundamental necessities of life - shelter and education - or to protect them from its harshest catastrophes -- medical expenses and long-term care. ASDA funds are deposited with after -tax dollars. The earnings on the funds accumulate tax-free, (or at least tax-deferred), and then, if a 5-year holding period is satisfied, the funds may be withdrawn tax-free for use as retirement income or for specified uses. By limiting the allowable tax-free purposes, the bill's authors assure that the accounts could not be used simply as a tax-deferral or avoidance mechanism.

NAR of course applauds H.R. 6 and any vehicle that might enhance our nation's very low savings rate. High capital formation and savings rates can have the effect of lowering interest rates, and low interest rates are always good for housing. Our greatest interest, of course, is the incentive for potential first-time homebuyers. We urge this Committee to incorporate such an investment incentive into any plan it reports to the House for consideration.

Be assured that NAR unequivocally supports investments that, in turn, encourage homeownership. We do, however, wish to point out that, as we understand the terms of H.R. 6, we will be past the year 2000 before any funds deposited in an ADSA would be available for use by first-time homebuyers. Thus, there is minimal immediate stimulative effect for housing. In order for the funds in an ASDA to be withdrawn tax-free, they must remain in the account for 5 years. Thus, funds deposited in 1996 would not be available for downpayments until the year 2000.

Moreover, it is not clear whether the 5- year holding period is a fixed or moving period. That is, if an individual deposited the allowed $2000 in the account beginning in 1996, and deposited $2000 each year thereafter, would funds deposited in 1998 be available for tax-free withdrawal in the year 2001, along with the 1996 funds, or would only the 1996 funds and their earnings be available in 2001? If the 5-year period is a moving period, then it would take 8-10 years, depending on the return on investments, to have $10,000 of tax-free funds available for a downpayment. Over the same 8-10 year period, however, the individual who put away $2000 a year in an ordinary interest bearing savings account would have $16,000 - $20,000 plus earnings available for a downpayment. While it is true that those earnings would have been taxed in an ordinary savings account, it is also true that under any measure, the ordinary savings accounts generates more funds for a one-time expenditure like a down-payment.

These observations apply, of course, only if the 5-year holding period is a moving measure. If the initial deposit creates the sole baseline for determining the holding period for all assets in the account, then all funds in the account would be eligible for tax-free distribution at the end of 5 years. Thus, on this assumption, if an individual opened an ADSA in 1996, and deposited $2000 yearly, then all $10,000, plus earnings, could be distributed tax - free beginning in 2001. Again, we note, that there is no current benefit to housing. Charts A and B illustrate the need for an incentive for homeownership for younger people. Those charts show a continued downward trend for homeownership in general, but an upward trend in the age for a first-time home purchase. Most importantly, the charts show that the incidence of homeownership among people under 35 is only half the rate of homeownership among all age groups over 45. These are alarming trends.

When young people are asked to identify barriers to homeownership, they invariably cite the difficulty of amassing a downpayment. Clearly, some incentives are appropriate.

ADSA's drafters may believe that the IRA rollover provisions in H.R. 6 provide an adequate mechanism for the accumulation of funds for a big-ticket item like a downpayment. In recent years, economists have learned that saving is a life-cycle process, and that younger people tend to save much less than middle-aged and older people. We would point out, however, that first-time home purchases generally occur in the young adult or very early middle age phases of an individual's life. Thus many prospective first-time homebuyers often have not yet begun to save through IRA's, precisely because they need the greater liquidity of other non-IRA, savings mechanisms to fund a downpayment. Thus, the rollover provision appears to be helpful for middle-aged and older Americans who have savings and use them for education expenses, medical expenses, long-term care needs or retirement. A rollover provision generally is of less benefit to a younger person who has saved outside of the IRA market in order to accumulate downpayment funds that would be subject to penalties if used before age 59 and 1/2.

A useful interim or transition device that the Committee may wish to consider is presently embodied in Senator Roth's bill S. 12, which contains an IRA proposal nearly identical to one that passed Congress twice in 1992, but was not enacted. This proposal permits a penalty-free withdrawal from an IRA or 401(k) plan for use as a downpayment by a first-time homebuyer. Significantly, it also permits a parent or grandparent to make penalty-free withdrawals to assist a child or grandchild in making a downpayment for a first-time home purchase. NAR actively advocated this approach in 1992, and strongly believes the "parent and grandparent pass-through " is crucial to making any new IRA plan a genuine vehicle for advancing first time home buying. It is our understanding that Rep. McCrery has been studying the merits of the "parent and grandparent pass-through" for purpose of first time home buying. NAR looks forward to working with Rep. McCrery and other members of the committee in strengthening the ADSA in this manner.

Accordingly, we would urge the Committee to modify H.R. 6 so that ADSA funds of a parent or grandparent can be used for a downpayment by a child or grandchild for the purchase of a first time home. This modification is consistent with the rule in H.R. 6 that applies to education expenses, and, again, would make the ADSA a far more significant tool to enhance homeownership.

H.R. 9 - JOB CREATION AND WAGE ENHANCEMENTS ACT OF 1995

Capital Gains

The National Association of Realtors® enthusiastically and actively supports all efforts to restore a meaningful capital gains differential. An exclusion and indexing are both important elements of a differential, and we fully support both provisions. In particular, we commend Chairman Archer and other committee co-sponsors for retaining current law on depreciation recapture. We will work aggressively to preserve the integrity of the bill as it concerns recapture, and urge the Committee to resist any effort to modify current law recapture treatment.

We also commend the Chairman for avoiding any temptation to expand the alternative minimum tax (AMT). The AMT is a backdoor, burdensome tax. We applaud the fact that certain incentives are not extended in one area only to be recouped through the AMT. The drafters did well in not extending its harsh impact.

Capital Gains and Real Estate -- One of the things that we know about Americans is that they buy real estate. Generally, they buy as much real estate as they can afford. They buy homes, condos, cottages at the lake, hunting lodges, speculative parcels, a safe new home for mother, and farms and ranches. It is no accident that one of our great American epics is Gone With The Wind - - a story of devotion to Tara and to the land.

The incidence of the ownership of real estate is more wide-spread than one might expect. Federal Reserve data in the Survey of Consumer Finances show a remarkably high incidence of ownership of real estate, other than a principal residence, by individuals in income classes below $50,000. The 1992 Survey shows that 63.8% of all families own a principal residence, and that 20% of all families own investment real estate. Among families with $25,000-$50,000 of income, 69% own a home, and a surprising 20% also own investment real estate. Among families in the $50,000-$100,000 income category, 85% own their home, and 30% own investment real estate.

The reasons for ownership are varied, and, some of those reasons, we fully admit, are likely to be influenced by the tax effects of ownership. The important fact to note is that real estate, in addition to a principal residence, is held more widely than CDs, mutual funds, stocks and bonds. Since it is widely held, the markets for it are large and diverse. We strongly believe that the power of those markets can be augmented through the unlocking power of reduced capital gains taxes. (Source: 1992 Survey of Consumer Finances, Federal Reserve Bulletin, Oct., 1994.)

One of the things that we can't measure in that market is pent-up demand. You can't after all, measure transactions that haven't occurred. Every Realtor® we meet, however, has stories to tell about properties that would have sold except that the tax beating of current law was too great. They have hardships stories, as well, about people in reduced circumstances forced to sell their assets, only to face large tax bills.

Our members tell us that the single most important issue in the Contract with America is capital gains. We urge the Committee to enact the provisions of HR 9, and we give our full support to that effort.

The Exclusion -- Before its repeal in 1986, the capital gains exclusion operated as a sort of rough justice to give taxpayers some incentive to hold property for the long haul, while giving an imprecise recognition to the effects of inflation on an investment. Real estate tends to be a very illiquid investment, so it was particularly important to the holders of real estate that some means of mitigating the impact of inflation would be available. The repeal of the capital gains exclusion in 1986 destroyed even that imprecise mechanism. Lower tax rates simply did not overcome the impact of removing the exclusion.

In 1993, we requested that this Committee review the impact of a tax rate increase as it would affect capital gains taxes. In 1993, President Clinton proposed, and Congress narrowly enacted, a tax rate increase. At the same time, the capital gains rate stayed constant at 28%, and was not increased. A little discussed anomaly thus arose. The effect of the higher tax rates was that one class of upper-income taxpayers enjoyed the benefits of the equivalent of a 30% exclusion, while families with less than about $85,000 of taxable income paid tax on all of their gain. Our 1993 testimony pointed out that fundamental disparity and urged this committee to review its fairness. Other issues took the spotlight, and that review did not occur. Nonetheless, a significant volume of capital gains transactions occurs for individuals with less than $85,000 of taxable income, even though the dollar amount is relatively small. Many of those taxpayers will have only a limited number of capital gains transactions in a lifetime, yet their limited number of assets are presently taxed less advantageously than the larger, diversified portfolio of an upper income individual. Now, the Contract offers the Committee an opportunity to redress the fundamental unfairness of having of creating two classes of taxpayers -- those with a capital gains differential, and those without a differential. We therefore vigorously support restoration of a 50% exclusion for all individuals.

Indexing -- NAR supports the provisions that permit indexing on a sale of assets. While many of our members would prefer that there would be a look-back provision, we acknowledge that such a provision would be costly to enact and to administer. We take no position on the choice of index used, but simply urge that the compliance provisions associated with administering an indexing scheme be as simple as possible. We look forward to working with the IRS to develop record-keeping and compliance programs that will be easily understood by taxpayers. Taxpayers will need some education about the record-keeping challenges posed by an indexing scheme, and we are committed to doing our part in assisting in that effort.

Loss on Sale of Principal Residence -- The idea of a loss on a sale of a principal residence was basically a foreign concept in most of our experience until about 1982-83. Then, the price of oil plummeted, and once prosperous housing markets slumped. Since then, regions as diverse as Los Angeles, New England, the Rocky Mountains and others have experienced reductions in value to housing prices and many families have incurred real, not paper, losses on sales of their homes.

The tax system has never permitted a homeowner to reflect this painful and very real economic loss. Chairman Archer for several years has sought to provide taxpayers relief from this type of personal economic catastrophe. Now, the Contract has incorporated his efforts to provide such relief. The Association's governing bodies will vote on that proposal next week, and we fully anticipate that they will give it their full support.

Depreciation -- Neutral Cost Recovery System

The Proposal - - H.R. 9 proposes a new Neutral Cost Recovery System (NCRS) designed to provide a taxpayer with the economic equivalent of expensing assets. In the case of real estate, the straight-line allowance is indexed for inflation so that, over time, the nominal amount of the depreciation allowance increases because of the compounding effects of inflation. Charts C and D illustrate these mechanics. Chart C presents a real estate asset with a depreciable basis of $39,000, and shows what the depreciation allowances would be under current law, under the present inflation scenario of 2.6 %, and at a higher rate of 5%. Chart D show those same results in graph form. Obviously, a period of higher inflation would produce even larger allowances and a steeper incline on the graph.

NAR has no formal position on NCRS, but the proposal is certainly consistent with our policy of supporting depreciation systems that reflect an economically viable recovery system for investment in an asset. We do, however, wish to share with you some of our concerns about NCRS.

NCRS is a very back-loaded regime. Hence, the significant tax benefits to do not begin to accrue until later years. In terms of budget scoring vocabulary, this means that the big revenue losses are outside the budget period. Because of this reality, we are very concerned about the prospects for having the rules change in midstream. After all, in 1981 the depreciable life for real estate was 15 years. In 1982: 18 years. In 1984: 19 years. In 1986, the life went to 31.5 years for commercial property. Even more significantly, the entire tax regime for real estate was turned on its head with the passive loss rules. The passive loss rules had the effect of a substantial retroactive tax increase on real estate. The loss of deductions and other financial and inventory factors combined to cause a decline in property value of as much as 30%. Our members know first-hand that the tax rules affecting real estate can change rapidly and retroactively, and with harsh punitive effects. It is not clear that investors would make an election to use NCRS in light of that knowledge. Moreover, the trade off between back-loaded deductions and the loss of indexed basis on disposition of NCRS properties is a troubling combination. It is difficult to assess the interaction of the depreciation and capital gains tradeoffs, because of the difficulty in projecting the variables of holding period and inflation.

We are grateful that the Committee is reviewing cost recovery, however, because there are some problems with current law. We are hopeful that the committee will be able to address these problems in the context of that review.

Tenant Improvements -- Throughout the debate (1988-1993) on the passive loss rules and other corrections to the taxation of real estate, our industry has recognized the requirements of the budget process, and has worked with this Committee to find ways to "pay for" the revisions we have sought. For good or for ill, the method that was chosen was to revise the rules for depreciation. Very reluctantly, NAR supported the 1993 proposal to extend depreciable lives of commercial real estate to 39 years, notwithstanding our regrets about the impact of that change. We accepted the changes to depreciation with the understanding that they were the means of "paying for" the 1993 efforts to improve real estate taxation.

We must comment, however, that extending the life of commercial property to 39 years exacerbates a gross distortion in one aspect of commercial development. When a developer or owner secures a new tenant for either a new or existing building, the developer or owner often must build out and configure the space to satisfy the needs of the tenant. Prior to the enactment of ACRS in 1981, the costs of these tenant improvements were amortized over the term of the lease. In 1981, when ACRS, with its artificial 15-year depreciable life for real estate was adopted, it was a reasonable tradeoff to drop this leasehold improvement amortization rule in exchange for the simplification brought about by lumping all costs of a structure into a single 15-year life for the entire property.

Now, however, we are light years away from a 15-year life, and the trade-off made in 1981 is no longer valid. It not unreasonable to assert that the life of a building shell can be the 31.5 years of pre-1993 law, or even the 39 years of current law. It is absurd, however, to believe that the interior elements of any structure will last that long. It is similarly absurd to think that the costs of improvements made for a tenant who may stay only for a period as short as 3-5 years, will last 39 years. Yet under current law, the costs of tenant improvements must be written off over 39 years. Even at the end of the lease, the remaining unamortized costs will remain outstanding, to be written off over the remaining unexpired depreciable life and not immediately deductible. This violates all familiar accounting concepts of matching income with expense, and does great violence to common sense and to the rate of return on the improvements.

As the Committee deliberates on cost recovery, we urge you to review this problem, and to find a solution to the problem of amortizing the costs of tenant or leasehold improvements. The optimal solution, of course, would be to apply traditional accounting concepts and match costs against the income, by returning to the pre-1981 rule that permitted the costs to be amortized over the term of the lease. If revenue constraints make this impossible, then we would be pleased to work with the Committee to craft a solution that more nearly reflects the reality of economic lives for these improvements. We understand that representatives Shaw and Rangel have been examining the problems inherent with current law in this area and are interested in developing a fair and balanced solution to this problem. We are appreciative of their efforts and look forward to working with them and other members of the committee in this regard.

In a slightly broader context, we note that many of our members have expressed interest in restoring some sort of modified component depreciation scheme to reflect the reality that few internal elements of a building last for anywhere near 39 years. We do acknowledge that abuses of this system occurred in the past, so we recognize that it would be important in moving toward a component-type system that safeguards against abuses be designed. We do not have a specific plan to advance at this time but would hope that such options could be explored with the Committee in the coming months.

Estate Tax Reforms -- NAR supports the expansion of the unified estate and gift tax credits.

Home Office Deduction -- NAR supports the clarification of the home office deduction provisions.

Expensing -- NAR supports the increase of the expensing provisions from $17,500 to $25,000.

CONCLUSION

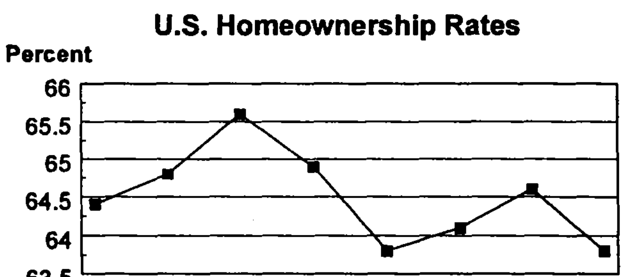
We appreciate this opportunity to express our views, and would be pleased to respond to your questions.

CHART A

HOMEOWNERSHIP RATES

During the 1980s, homeownership declined. High mortgage rates and home price inflation of the 1970s and early 1980s prevented young households from making the step to homeownership. Moreover, demographic factors, such as, the growth of single-person and single-parent households, prevented many young households from becoming homeowners. Even the percentage of young married households, who historically become homeowners, fell during this period.

During the early 1990s, a slight upward trend in homeownership began to emerge. Increases in homeownership by older households led the way. However, with the continual increase in mortgage interest rates in 1994, since they reached a 25-year low in October of 1993, the trend has begun to reverse itself.



Years	1973	1976	1980	1983	1986	1990	1993	1994 Qtr 2
■	64.4	64.8	65.6	64.9	63.8	64.1	64.6	63.8

Source: Joint Center tabulations of the 1973,1976, and 1980 American Housing Surveys, and the 1983, 1986 and 1993 Current Population Surveys

CHART B

HOMEOWNERSHIP RATES

Secong Quarter: 1994

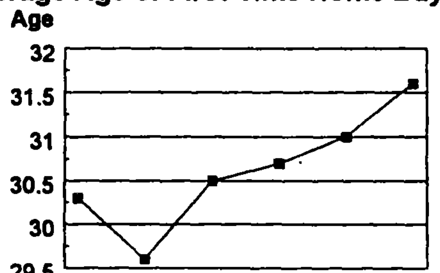
(in percent)

Homeownership Rates	
United States	63.8
Northeast	61.3
Midwest	67.5
South	65.2
West	59.7

Homeownership Rates by Age of Householder	
Less Than 35	36.8
35 to 44	64.6
45 to 54	75.2
55 to 64	79.1
65 and over	77.2

Data Source: U.S. Census Bureau- Housing Vacancies and Homeownership - 2nd Qtr 1994

Average Age of First-Time Home Buyer



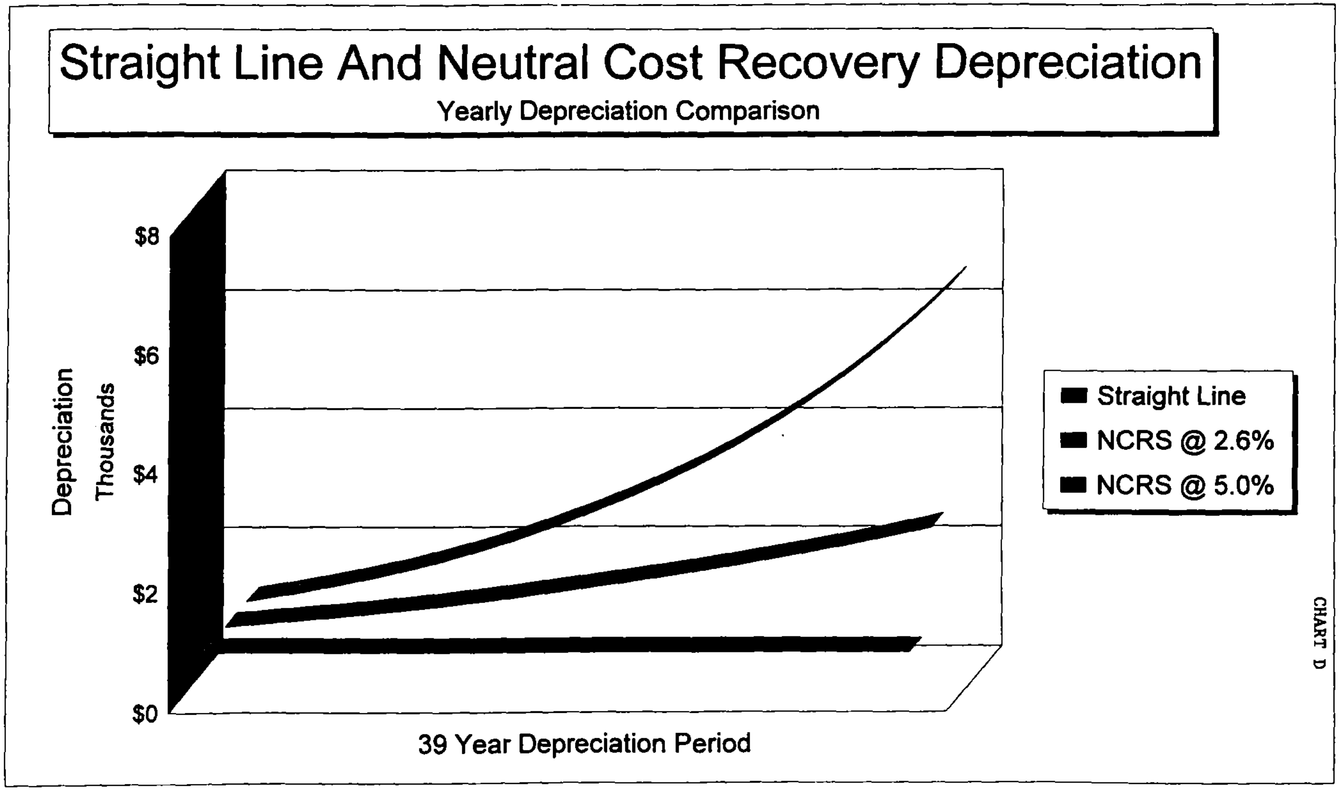
Years	1988	1989	1990	1991	1992	1993
-■-	30.3	29.6	30.5	30.7	31.0	31.6

Data Source: Chicago Title and Trust Company

CHART C

Comparison of Straight Line And Neutral Cost Recovery Depreciation Methods

Period	Year	Straight Line Deprecation	Neutral Cost Recovery @ 2.60%	Neutral Cost Recovery @ 5.00%
1	1995	$1,000	$1,000	$1,000
2	1996	$1,000	$1,026	$1,050
3	1997	$1,000	$1,053	$1,103
4	1998	$1,000	$1,080	$1,158
5	1999	$1,000	$1,108	$1,216
6	2000	$1,000	$1,137	$1,276
7	2001	$1,000	$1,166	$1,340
8	2002	$1,000	$1,197	$1,407
9	2003	$1,000	$1,228	$1,477
10	2004	$1,000	$1,260	$1,551
11	2005	$1,000	$1,293	$1,629
12	2006	$1,000	$1,326	$1,710
13	2007	$1,000	$1,361	$1,796
14	2008	$1,000	$1,396	$1,886
15	2009	$1,000	$1,432	$1,980
16	2010	$1,000	$1,470	$2,079
17	2011	$1,000	$1,508	$2,183
18	2012	$1,000	$1,547	$2,292
19	2013	$1,000	$1,587	$2,407
20	2014	$1,000	$1,629	$2,527
21	2015	$1,000	$1,671	$2,653
22	2016	$1,000	$1,714	$2,786
23	2017	$1,000	$1,759	$2,925
24	2018	$1,000	$1,805	$3,072
25	2019	$1,000	$1,852	$3,225
26	2020	$1,000	$1,900	$3,386
27	2021	$1,000	$1,949	$3,556
28	2022	$1,000	$2,000	$3,733
29	2023	$1,000	$2,052	$3,920
30	2024	$1,000	$2,105	$4,116
31	2025	$1,000	$2,160	$4,322
32	2026	$1,000	$2,216	$4,538
33	2027	$1,000	$2,274	$4,765
34	2028	$1,000	$2,333	$5,003
35	2029	$1,000	$2,393	$5,253
36	2030	$1,000	$2,456	$5,516
37	2031	$1,000	$2,519	$5,792
38	2032	$1,000	$2,585	$6,081
39	2033	$1,000	$2,652	$6,385
Totals		$39,000	$66,197	$114,095


Straight Line And Neutral Cost Recovery Depreciation
Yearly Depreciation Comparison
$8
$6
$4
$2
$0
Depreciation
Thousands
Straight Line
NCRS @ 2.6%
NCRS @ 5.0%
39 Year Depreciation Period
CHART D

Mr. HERGER. Thank you very much for your testimony, Mr. Woods.

Mr. Didion.

STATEMENT OF JAMES J. DIDION, CHAIRMAN, NATIONAL REALTY COMMITTEE, AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CB COMMERCIAL REAL ESTATE GROUP, LOS ANGELES, CALIF.

Mr. DIDION. Thank you, Mr. Chairman and members of the Ways and Means Committee, good afternoon. My name is Jim Didion and I am chairman of the National Realty Committee, real estate's roundtable in Washington.

NRC members are engaged in all aspects of the real estate business as leading owners, advisers, builders, investors, lenders and managers. While not in Washington on NRC's behalf, I am typically traveling the company on behalf of my company, CB Commercial, or at work in Los Angeles where we headquarter in California. I am chairman and CEO of CB Commercial, one of the Nation's largest diversified commercial real estate companies.

The National Realty Committee appreciates the opportunity to present testimony today regarding select provisions of the Contract With America's Job Creation and Wage Enhancement Act.

Federal tax policy should be rational and balanced and serve as neither a disincentive to prudent real estate investment nor an incentive to unjustifiable excessive real estate investment. As an illustration of our long-term commitment to prudent policy, in 1981, the NRC testified against overly generous depreciation for nonresidential real estate. At that time, we believed that such a policy would lead to the economic overpricing and overbuilding of assets.

Indeed, given real estate's significant role in our Nation's economy, America's cities, all taxpayers and savers have a stake in reasonable growth-oriented real estate tax policy and the sound real estate asset values that such policy helps ensure.

Today, I would like to offer NRC's views on two critical issues being addressed by this committee, capital gains and depreciation. Regarding both issues, NRC believes Tax Code modifications are necessary so that real estate assets and business activities are taxed fairly, consistently, and accurately over time. So that capital formation, economic growth, and urban investment are facilitated and so that traditional real estate cycles are not unnecessarily exaggerated.

Specifically, a lower capital gains tax would help assure sound real estate asset values, encourage business activity, and spur economic growth. All of which are deterred by today's excessively high capital gains tax.

It should come as no surprise then that NRC strongly supports the capital gains tax reforms contained in the Job Creation Act. Why?

First, the act would cut the capital gains tax to a more appropriate line to incent savings through investment and assets; second, it would allow for indexing so that inflationary gains are not taxed; third, it would apply to currently held as well as newly acquired assets; fourth, it would apply to individually held and corporately held assets; and fifth, the proposal very importantly maintains real estate's historical depreciation recapture treatment.

In a nutshell, this is the most thoughtful capital gains proposal I have seen in 15 years. It represents sensible change and it should be adopted.

Regarding depreciation, NRC also views inclusion of a neutral cost recovery system in the Contract With America as conceptually a significant and positive step. We agree that the current depreciation system should be reviewed and modified. In the case of real estate, it is the so-called leasehold improvements issue which I will explain briefly that NRC views as the most egregious flaw in the current system and one that should be addressed most immediately.

Simply stated, leasehold improvements, improvements constructed specifically for tenants, are the internal building components that are typically reconfigured, changed or somehow improved on a regular basis to meet the changing need of new and existing tenants; internal walls, ceilings, partitions, plumbing, lighting and finishes, these and all the elements that might be part of improvements made within a building shell to accommodate a specific tenant's requirements.

The problem with respect to the Tax Code is that today's depreciation rules don't differentiate between the life of tenant improvements which typically corresponds with the tenant's lease term and the life of the overall building structure. Current rules subject both to a 39-year depreciation schedule even though tenant improvements, in most cases, have absolutely no useful life beyond the average lease term of 7 to 10 years.

Compounding the problem is significant ambiguity concerning whether a real estate owner can close out and deduct currently any unrecovered costs at the time a leasehold improvement is destroyed. To make matters worse, the current policy works against urban reinvestment and construction job opportunities as improvements are delayed or not undertaken at all. And a widespread shift to more energy efficient environmentally sound building elements is discouraged because of their typically higher expense.

To address this issue, the cost of leasehold improvements should be recoverable over the improvement's true useful lives, such as the lease term or some other time period necessarily much shorter than today's 39-year requirement. Equally important, it should be clarified that owners are permitted to fully deduct and close out any unrecovered leasehold improvements expenses remaining at the time a leasehold improvement is demolished.

Both Congressman Shaw and Congressman Rangel, as well as others on this committee, have shown a great deal of interest on this issue and we look forward to working with them and you, Mr. Chairman, toward corrective action.

In conclusion, Mr. Chairman, the National Realty Committee again wishes to express its thanks for the opportunity to testify here today. We are encouraged by the tax proposals contained in the Contract's capital gains and depreciation reform and we are pleased to join down the path for a more rational, reasonable and growth oriented Tax Code.

Thank you.

[The prepared statement follows:]

TESTIMONY OF JAMES J. DIDION
NATIONAL REALTY COMMITTEE

Introduction

Mr. Chairman, members of the Ways and Means Committee, good afternoon. My name is Jim Didion. I am chairman of National Realty Committee, and chairman and CEO of CB Commercial Real Estate Group, one of the nation's largest diversified commercial real estate companies.

We appreciate the opportunity to present testimony today regarding select provisions of the Contract With America's Job Creation and Wage Enhancement Act.

National Realty Committee believes that federal tax policy should be rational and balanced . . . and serve as neither an incentive to unjustifiable, excessive real estate investment nor a disincentive to prudent real estate investment. That's why in 1981 NRC testified before Congress against overly generous depreciation for nonresidential real estate, believing such a policy inevitably would lead to uneconomic overpricing and overbuilding of assets. And that's why in 1986 we strongly urged that Congress reject the passive loss proposals, believing that those rules would undermine the economics of real estate values, increase bankruptcies and cause great stress to lenders and local tax bases.

Indeed, given real estate's significant role in our nation's economy, America's cities, taxpayers and savers all have a stake in reasonable, growth-oriented real estate tax policy and the sound real estate asset values that such policy will help ensure.

We welcome the opportunity to work with you, Mr. Chairman, and members of this Committee, to enact a set of positive tax laws for real estate and the nation. Combined with the positive economic and market factors now in place, rational government policies toward real estate should help sustain the current real estate recovery and minimize unnecessary and unusual exaggerations in real estate cycles. As recent history illustrates, secure real estate asset values and adequate liquidity are important keys to ensuring that the national economy is in a position to enjoy long term economic growth and good health.

Summary

Today I'd like to offer NRC's views on two critical issues included in the Contract With America's Job Creation and Wage Enhancement Act: capital gains and depreciation tax reform.

Regarding both issues, NRC believes tax code modifications are necessary so that real estate assets and business activities are taxed fairly, consistently and accurately over time . . . so that capital formation, economic growth and urban investment are facilitated . . . and so that the heights and depths of real estate cycles are not unnecessarily exaggerated.

Specifically, a lower capital gains tax, as proposed in the Contract With America, would help assure sound real estate asset values, encourage business activity and spur economic growth — all of which are deterred by today's excessively high capital gains tax.

At the same time, today's depreciation rules are inadequate and they should be modified so that they recognize the true economic life of buildings and the leasehold, or tenant, improvements made to them.

Capital Gains Taxation

National Realty Committee strongly supports the capital gains tax reforms contained in the Contract With America's Job Creation and Wage Enhancement Act. Here's why.

The Contract's capital gains reforms would cut the capital gains tax and thereby increase liquidity and unlock investments.

The combined burden of federal, state and local taxes on capital gains makes it more difficult to raise capital for needed and appropriate acquisitions, refinancings, and development opportunities. All of which are the source of much economic vibrancy, innovation and job creation. In addition, there is a strong disincentive in many cases to dispose of real property because of the relatively high rates of tax on gain. This "lock-in" effect discourages the employment of real estate in its highest and best use. Unlocking investments is vital to the optimum functioning of an efficient economy.

The Contract's capital gains reforms would adopt an indexing system so that inflationary gains are not taxed.

Gain on the sale of real property is strongly influenced by inflation. Even at low rates of inflation, taxpayers who sell real estate at a nominal profit are paying tax on a fictional element of profit represented by inflation. Eliminating the tax on inflationary gains is logical and wise long term tax policy. However, we do want to bring to the Committee's attention two shortcomings we see in the indexation provision as written.

First, we note with some concern that this indexation proposal would not apply to so-called "net leased" assets. We believe that the definition in the legislation of a net leased asset is too broad (for example, we would urge at a minimum that only "fixed" options to renew be counted). We urge the Committee to look closely at this provision as many real estate assets may be arbitrarily and unintentionally excluded.

In addition, the indexation feature as drafted would not appear to completely account for the affects of inflation on depreciable real property. This can best be illustrated by noting that the provision would deny any benefit to an asset whose adjusted basis is zero — that is, any asset held for its entire projected useful life. This is because, under the proposal, indexed basis is to be substituted for adjusted basis in calculating gain. Indexed basis is to be determined by multiplying adjusted basis by an inflation factor in the year of sale. If adjusted basis is zero, indexed basis will be zero — therefore denying inflation indexation benefits to precisely those assets held the longest. Arguably, indexing "adjusted basis" may be appropriate in cases where the asset receives, through the depreciation system, the present value of expensing. But since real estate assets do not, and are not proposed to, receive such treatment under this proposal, this capital gain indexation approach does not adequately account for inflation. Indexation of original cost is likely a more appropriate approach in real estate's case.

We would welcome discussing this matter in greater detail with the Committee staff.

The Contract's capital gains reforms would apply to currently held assets as well as to assets acquired subsequent to the enactment of the legislation.

Although some have suggested that a capital gains tax cut should apply solely to new investments, we strongly disagree. To exclude currently held investments from a capital gains tax cut would substantially devalue such assets and introduce very troubling implications for lenders and local tax bases, to say nothing of the owners. We urge any capital gains reform to apply to all assets — currently owned assets as well as those that are later acquired.

The Contract's capital gains reforms would apply to individually held and corporately held assets.

We see no justifiable tax policy reason for excluding a class of taxpayers and we therefore support this aspect of the Contract With America.

The Contract's capital gains reforms importantly maintain real estate's historical depreciation recapture treatment.

The current depreciation recapture rules, in place for over 30 years, are consistent with sound tax policy. These rules, which determine the portion of gain-on-sale taxed at the ordinary income versus the capital gains rate, recognize that buildings are long-lived assets that deteriorate over time, and they appropriately allow recaptured real economic depreciation deductions to be taxed as capital gain rather than ordinary income, which they clearly do not represent. As a consequence, these rules prevent taxpayers from converting ordinary-income deprecation deductions in excess of economic depreciation into capital gain upon a real property sale or disposition. Replacing this current system with one that taxed all recaptured depreciation deductions as ordinary income, as is sometimes suggested, would deny the fact that buildings and their internal systems do in fact depreciate. In addition to having no policy justification, a full recapture system also would have the net result of increasing taxes on any real estate sale at or slightly above original cost. We support the Contract With America depreciation recapture system, it is correct long term policy, and we urge its inclusion as part of any overall capital gains tax reform.

In a nutshell, the Contract With America capital gains reforms are the most thoughtful and effective capital gains proposal we've seen in many years; they represent sensible change and, with technical modifications to the indexation provision, we urge their swift enactment.

Depreciation

National Realty Committee views the inclusion of the Neutral Cost Recovery System in the Contract With America as a significant and positive step. We agree that the current depreciation system should be reviewed and modified to better reflect the true economic useful lives of assets. Indexation of depreciation deductions for inflation is one approach to partially achieving this goal.

But for depreciable real estate, the most egregious flaw in the current system, and the one that should be addressed most immediately, concerns the depreciation system for leasehold improvements.

Simply stated, leasehold, or tenant, improvements are the internal building components that are typically reconfigured, changed or somehow improved on a regular basis to meet the needs of new and existing tenants. Internal walls, ceilings, partitions, plumbing, lighting and finish — these are all elements that might be part of improvements made within a building shell to accommodate a tenant's requirements and therefore ensure that a tenant leases space.

The problem with respect to the tax code is that today's depreciation rules don't differentiate between the life of a tenant improvement — which typically corresponds with a tenant's lease-term — and the life of the overall building structure. Current rules subject both the building shell and all its internal improvements to a 39-year depreciation schedule, even though tenant improvements, in most cases, have no useful life beyond the average lease-term of seven to ten years. Correcting this mismatch between income and expense should be a priority.

Compounding this problem is significant ambiguity in the marketplace today concerning whether a real estate owner may "close out" and deduct currently any unrecovered costs remaining at the time a leasehold improvement is destroyed. It seems almost absurd, but the current rules are in some cases being interpreted to deny the ability of a building owner to "close out" its investment for tax purposes even though the improvement has been scrapped, demolished or otherwise permanently retired from service. Theoretically, in 30 years a building owner could have had 6 different 5-year tenants, each requiring different improvements to accommodate their individual business needs. Because of the current confusion, the owner may be required to depreciate improvements that in fact no longer exist. In addition to more closely matching income from the improvement with its costs, this close out issue needs to be addressed.

As a result of today's flawed depreciation rules, the after-tax cost of reconfiguring, or "building out", space to accommodate new tenants is artificially high. This is because owners are unable to fully deduct the economic costs expended on leasehold improvements over the period in which the improvements actually generate income.

In addition, the current policy hinders urban reinvestment and construction job opportunities as improvements are delayed or not undertaken at all. And a widespread shift to more energy-efficient, environmentally sound building elements is discouraged because of their typically higher expense.

To address this issue, the cost of leasehold improvements should be recoverable over the improvements' useful lives . . . such as the lease-term or some other time period necessarily much shorter than today's 39-year requirement.

Equally important, it should be clarified that owners are permitted to fully deduct and close out any unrecovered leasehold improvement expenses remaining at the time a leasehold improvement is demolished.

We are pleased that several members of this Committee, including Congressmen Shaw and Rangel, have expressed concern with this aspect of the current depreciation system. We look forward to working with them, with you, Mr. Chairman, and with this Committee, toward corrective action in this important area.

Longer term, NRC believes the current one-size-fits-all real estate depreciation system should be examined and reformed to recognize the true economic lives of buildings and all their various component parts. We aren't, after all, talking about an undifferentiated commodity, but assets of a range of different varieties, shapes and sizes, uses and useful lives. Our current depreciation system needs greater flexibility to more accurately account for this diverse asset class.

Conclusion

National Realty Committee is encouraged by the tax proposals contained in the Contract With America — capital gains and depreciation reform — and we're pleased to join you down the path toward a more rational, reasonable, growth-oriented federal tax code.

Thank you.

Mr. HERGER. Thank you for your testimony, Mr. Didion.

Our next panelist is a constituent of our esteemed colleague from Washington, Jennifer Dunn.

Jennifer, would you mind introducing Mr. Freeman?

Ms. DUNN. Thank you very much, Mr. Chairman, and colleagues on the committee. It is a personal pleasure for me to introduce to my colleagues, Kemper Freeman, a long-time friend and a school classmate of mine. He comes before the committee as the president of the International Council of Shopping Centers and as owner of a regional shopping center in Bellevue, Wash., which is in my district.

Mr. Freeman is no stranger to leadership, to advocacy or to legislation. He has been a leader ever since I knew him at Bellevue High School. Like his father and grandfather before him, he has been an articulate and outspoken leader in the Northwest business community.

Beyond that, he has also served with great distinction in Washington State's Legislature. As you will see, he brings particular knowledge and insight to some of the most pertinent tax issues before our committee.

And it is my great pleasure and privilege to introduce to you a gentleman I know as a leader, an expert, a friend, and what I have been told, a pretty adept Harley-Davidson driver, Kemper Freeman.

STATEMENT OF KEMPER FREEMAN, JR., PRESIDENT, INTERNATIONAL COUNCIL OF SHOPPING CENTERS, AND PRESIDENT, KEMPER DEVELOPMENT CO., BELLEVUE, WASH.

Mr. FREEMAN. Thank you, Jennifer. I think I should thank you for letting me be here. I wish my mother could have heard all of that.

Mr. Chairman, and distinguished members of this committee, it is indeed an honor to join you today and speak on behalf of the ICSC in favoring your Job Creation and Wage Enhancement Act of H.R. 9. As Congressman Dunn said, I am Kemper Freeman, owner and manager of Bellevue Square and Bellevue Place, president of Kemper Development in a city near Seattle in the other Washington.

It is my pleasure this year to serve as chairman and president of the ICSC, which is an industrial organization of the nearly 39,000 shopping centers, mostly small shopping centers, and our organization is made up of approximately 27,000 members.

We are here today specifically to address the capital gains issue, and I would like to give some testimony on that.

I believe it is time that we break the myth that capital gains tax reduction is only for the benefit of the rich. It is simply not true. I can explain that by pointing out, in our industry, the capital is the first thing in. That buildings, jobs, and tax base come along sometimes over many years after the original capital is put in. And only when and if the project becomes successful, successful enough so that the capital has become more valuable, only then does the person who put up the original money get to take out more than they put in. We are the first money in. We are the last to get paid.

And the fact is, all America wins when the capital gains tax is reduced.

We also believe that in this bill there are several other things that will be corrected, and the myth of inflationary gains right now are taxed by the full rate of capital gains. And investments sometimes take years to come out of a project and, oftentimes, the entire gain is simply the inflation that took place while that capital was tied up, and in every case, a large portion of the gain is inflationary.

And this bill, as I understand it, would correct that. Also, the lock-in effect of capital, because this rate is so high now, now one with any common sense would take capital out of a project, suffer up to a third of its being destroyed by the existing tax, only to reinvest in the next project. And this makes us less competitive and less able to get at the capital to deploy it where it best should be and that is, the most viable projects.

You have seen in our industry that many of us have been forced to borrow heavily rather than take equity from one place and move it to another because of the severe penalty. The ICSC strongly supports the capital gains legislation that we are talking about today. And this legislation presents the best opportunity for the Nation's economy unlocking real estate investment to spur economic growth and jobs.

Cutting the capital gains tax rate and the resulting economic growth will significantly lower the cost of capital for the Nation's real estate investors, and for that we are deeply appreciative.

The inflation indexing will eliminate the taxing and fictional element of property values. Shopping centers are one of the largest employers in the United States, with direct employment of over 10 million jobs, representing approximately 9 percent of all the people who work in America, work in these centers, and with your help, there will be more investment and simply more jobs.

While we support this bill and are deeply thankful for your help in moving it along, we do want to offer an amendment as to the net lease, a technical correction. Most of our industry deals with net leases and I think the net lease provision is in there to try and correct some other problem, but our industry is sort of the dolphin in the net, and we really shouldn't be caught in that net.

The ICSC strongly supports this capital gains bill, and all America will love you for passing it.

Thank you.

[The prepared statement follows:]

Testimony
of the
International Council of Shopping Centers
on
The Capital Formation and Job Creation Act of 1995 (H.R. 56)
Presented to
The Committee on Ways and Means
U.S. House of Representatives
By
Kemper Freeman, Jr.
President
Kemper Development Company

January 26, 1995

I. Introduction

I am Kemper Freeman, President of Kemper Development Company located in Bellevue, Washington. I am also the elected President of the International Council of Shopping Centers (ICSC) and I am appearing today on behalf of ICSC. My testimony today will focus on the capital gains provisions contained in The Job Creation and Wage Enhancement Act of 1995 which have also been introduced separately as The Capital Formation and Job Creation Act of 1995 (H.R. 56).

The International Council of Shopping Centers (ICSC) is the trade association of the shopping center industry. Its 27,000 members represent owners, developers, retailers, lenders, and all others having a professional interest in the shopping center industry. Its 24,500 U.S. members represent almost all of the 39,000 shopping centers in the United States. In 1993 these centers accounted for $830.2 billion in retail sales, over 55% of all non-automotive retail sales. In addition, shopping centers employed 10 million people, about nine percent of non-farm jobs in the United States.

II. Capital Gains Tax Treatment

A. Current Law

Prior to 1987, assets such as corporate stocks and bonds, land and depreciable property used in a trade or business were accorded special "capital gain" treatment on disposition, which resulted in a lower rate than the ordinary income tax rate. Since 1987, the capital gains of individuals have been taxed at ordinary income rates up to a maximum of 28 percent.

B. Background

From 1921 to 1987, non-corporate capital gains were taxed at reduced rates. From 1942 to 1987, land and depreciable real property used in a trade or business ("section 1231 assets") were accorded net capital gain and ordinary loss treatment. From 1921 to 1942, a maximum 12.5 percent tax rate was prescribed for capital gains. From 1942 to 1986, the basic structure of the capital gains tax was an exclusion of a portion of the gain from income (50 percent from 1946 to 1978, and 60 percent from 1978 to 1986) with a tax rate lower than the ordinary income rate applied to the non-excluded portion of the capital gain.

The Tax Reform Act of 1986 repealed the capital gains tax preference for all capital assets and Section 1231 property and all capital gains of individuals were taxed at the same rates as ordinary income subject to a maximum rate of 28%. However, rules regarding capital gains were left in the Internal Revenue Code in case a capital gains differential was reinstated. As part of the 1990 budget summit agreement, a top rate of 31 percent for individuals was instituted for ordinary income, but the top rate for capital gains was maintained at 28 percent. In 1993, the top rate for ordinary income of individuals again was raised, while the top rate for capital gains was maintained at 28 percent.

Corporate capital gains are governed by somewhat different rules with a current maximum rate for capital gains of 35%.

III. **Reasons For Capital Gains Tax Reduction**

ICSC believes that a significantly lower tax on capital gains from capital and other assets such as real estate must be reinstated to encourage economic growth, to improve long-term productivity, and to make the nation more competitive (most other nations do not tax, or impose a very low tax, on capital gains). In addition, the reduction of the taxation of capital gains will reduce impediments to the efficient functioning of the economy and improve the fairness of the tax system. Among the reasons for lowering the tax on capital gains are the following:

A. Economic

It is vital to the strength of the U.S. economy that the tax system facilitate the growth of new business and job formation, product and process innovation, and development of new and emerging technologies.

Investments in depreciable real property materially improve the growth and productivity of the economy and are important to our competitive position in the world.

Buildings that are energy efficient, that facilitate modern communications and information processing, and that are safe and comfortable encourage the effective and efficient performance of workers in them. Investments in modern office buildings assist the work of knowledge-based workers. Investments in industrial space, warehouses, and shopping centers and other retail facilities make the entire production-distribution system more efficient. Multi-use facilities integrate residential units, commercial office space, hotels and retail outlets all in one combined facility, bringing broad segments of the economy together in one location, and making it easier for each segment to access the services of another.

The development of high technology office, manufacturing, warehouse, and retail facilities help create value that is passed on to tenants who share their productivity gains from occupying efficiently designed space with their customers and clients.

Obtaining the investment necessary to develop these modern commercial facilities requires the creation and long-term commitment of capital and will be positively effected by a reduction in the taxation of capital gains.

B. Inflationary Gains

Because of inflation, building values would need to increase over time in order to maintain a constant value. Even at low rates of inflation, each year that passes increases the distortion between original and nominal values, especially for assets held for long periods of time, such as real estate. Thus, owners who sell capital assets at a nominal profit pay tax on a "fictional" element of capital gain represented by inflation and may be paying a tax on capital.

Therefore, capital gains from capital and other assets such as real estate should be taxed at a lower rate than ordinary income to compensate for this problem.

C. Lock-in of Investments

Another reason supporting a reduced tax rate for capital gains is to avoid "locking in" investments.

The "penalty" of paying ordinary rates on the gain from the sale of property "locks-in" real estate and other investments and impairs their free alienability. This prevents real property and other assets from being employed in their highest and best use, which is vital to the functioning of an efficient economy.

The investment in real estate in the U.S. is such a large percentage of total private domestic investment that any decrease in the efficiency of its allocation can have significant aggregate economic effects.

Real estate provides some of the best examples of the problems associated with "lock-in". For example, "lock-in" may prevent the disposition of a family-owned property upon retirement or a taxpayer's reallocation of his assets to a more efficient use. There is a direct negative effect on growth, jobs, and prosperity, from the higher rates of tax on gain which tend to discourage the natural economic evolution of the changing use of real properties. For example, old industrial loft space may be sold and then converted to residential units or retail uses, thus freeing up capital to build new industrial space and provide rehabilitated space for new uses.

Thus, the disincentive to dispositions of real property because of the relatively high rates of tax (federal, state, and local) on gain, and the consequent reduction in the funds available for reinvestment in another structure, is quite strong in some circumstances for owner-operators. The disincentive may be even stronger for lessors, whose decisions on the disposition of their property are more independent of the particular situation of any individual business and more based upon aggregate financial incentives and disincentives.

Reducing the tax on sales of existing and new assets would make it economic to sell property subject to the lock-in effect now and in the future. Increased sales of property will create greater economic activity, improve the efficiency of the economy, and increase federal revenues -- a tax is only paid when property is sold or transferred.

D. Bunching

Still another reason for reducing the tax on capital gains is the "bunching" problem.

"Bunching" occurs when gain, both real and inflationary, that has accumulated over several years is taxed in one year. This pushes the income of the taxpayer, including the income that otherwise would have been taxed at a lower tax rate, into a higher tax bracket in that year.

The "bunching" problem typically is more severe the longer the holding period because more years of accumulated gain are taxed in one year. Investments in real estate typically are held for longer periods than many other investments. Therefore, bunching generally is a more serious problem for real estate than for other assets.

In addition, the "bunching" problem is more widespread the greater the number of investors who would be in a lower tax bracket except for a sale with significant gain. Investments in real estate are more evenly distributed by income class, and therefore by tax bracket, than investments in other assets. Therefore, "bunching" may be a more widespread problem for real estate than for other assets.

IV. *The Capital Formation and Job Creation Act of 1995*

A. Provisions

The Capital Formation and Job Creation Act of 1995, H.R. 56, addresses the problems discussed above through its provisions, including these that follow:

- a deduction from gross income of fifty percent of net capital gain (thereby reducing the capital gain tax rate to one-half the rate on ordinary income) and a reduction in the impact of the phase-out of the personal exemption and the limitation on itemized deductions;

- the flow through to individuals and corporations of the fifty percent deduction from pass-through entities, such as partnerships, REITs, S corporations, etc.;

- the exemption of the fifty percent deduction of net capital gain from the alternative minimum tax;

- the indexation of the "adjusted basis" of capital and certain other assets to eliminate purely inflationary gains; and

- a provision to treat the loss on the sale of a home as a capital loss.

The 50% capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1995. The capital gains indexation would apply to inflation (and sales of capital assets) occurring after December 31, 1994.

B. ICSC Support

ICSC believes that the provisions of H.R. 56 are consistent with the principles for action on capital gains enunciated and supported by ICSC and its members over the years and supports its enactment. ICSC urges the Committee and the Congress to act promptly in enacting H.R. 56 as a means of encouraging the growth of jobs and the economy.

C. Issue of Concern

However, ICSC does have concern that the provision in the legislation that excludes net lease property[1] from the assets eligible for indexation may have a serious negative impact on shopping centers and believes that it needs to be reviewed by the Committee as to its purpose and scope.

ICSC is concerned that this exclusion and the definition of net lease property on which it is based may be inappropriate in the context of shopping center and other leases. This is particularly so regarding shopping centers because of reasons related to the history and unique nature of the shopping center industry.

A shopping center is a special type of commercial real estate that involves a unique interdependence and synergy between and among the shopping center and its tenants. Shopping center tenants pay to be located in a setting where they cooperate and compete with other retailers because of the high volume of customers attracted to the center by the combination of retailers and the facilities and amenities of the shopping center.

The shopping center landlord designs the "tenant mix" of the center to maximize the customer traffic to be drawn from the center's "market area" by leasing to those retail stores that in combination will be most attractive to the potential customers in the market area. The shopping center landlord creates the desired tenant mix by choosing retail tenants based on their nature or "use", their quality, and their contribution to tenant mix and by entering into leases which set forth and limit the uses to be made of the premises and the conditions and terms of operation within the center. Rents reflect the desirability and uniqueness of the tenant's use in relation to the tenant mix and vary among tenants on this basis.

Often, the shopping center landlord's rental income is directly tied to the success of the shopping center through "percentage rents", i.e., rent based on a set base amount and an additional percentage of the lessee's gross sales. The shopping center tenants join together and pay common area maintenance fees and other fees to provide for the maintenance, operation, and advertising of the shopping center in cooperation with the landlord who bears the costs of managing and operating the center. In addition, many tenants control, operate, and maintain their own HVAC systems independent of that of the shopping center and pay the costs associated with heating, cooling, lighting, and maintaining their space. The terms of these leases generally vary from 5 to 20 years and usually contain one or more options to renew.

While these leases facilitate the creation and operation of shopping centers and have contributed to the growth, modernization, and increased efficiency of the retail sector of the U.S. economy, in some instances they may meet the definition of "net lease property" in H.R. 56 and may not be eligible for indexation under its provisions.

ICSC believes that it would be inappropriate and unfair to deny indexation to the large number of shopping center leases that may qualify as net lease property under the definition in H.R. 56 and urges the Committee to examine this provision of the legislation.

V. **Conclusion**

ICSC strongly supports the provisions of the Job Creation and Wage Enhancement Act of 1995, and urges the Committee and the Congress to promptly pass the legislation.

In addition, ICSC asks that the Committee examine the net lease property provision and clarify its application, particularly as to shopping center leases.

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[1]In the legislation, the term "net lease property" means leased property where -- (A) the term of the lease (taking into account options to renew) is 50 percent or more of the useful life of the property: and

(B) for the period of the lease, the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) is 15 percent or less of the rental income produced by such property.

Mr. HERGER. Thank you very much Mr. Freeman.

And our final panelist, Mr. Johnson, please.

STATEMENT OF CALVIN H. JOHNSON, PROFESSOR OF LAW, UNIVERSITY OF TEXAS, AUSTIN, TEX.

Mr. CALVIN JOHNSON. I am Calvin Johnson from the University of Texas Law School. I teach tax and accounting at Texas.

My statement is on three errors in the neutral cost recovery system proposal and I propose to follow along fairly closely on the first 2 pages of that statement. You can both hear and read me simultaneously, if you would like.

Title II of the Contract With America would allow taxpayers to elect a complicated new depreciation system NCRS. The logic of the system is that taxpayers should be given tax savings worth the value of expensing, which means that one gets to deduct one's investment immediately as soon as the equipment is set up for use, although no resources have been lost.

The NCRS proposal involves a number of serious errors. Left uncorrected, the errors make NCRS an irresponsible or ideological proposal. In the political excitement of the moment, it is too easy to let professional standards go by the way, but politics needs calm deliberation and dispassionate analysis. We need to slow down and correct these errors or we will regret at leisure. The mistakes are too important to be lost.

The first error relates to tax shelters. The first error of the NCRS proposal is that it creates negative tax or subsidies more valuable than just freeing investment from tax. It does this first by combining expensing with interest deductions, and second, by combining expensing with lower capital gains rates.

The proposal, for instance, allows both the expensing of the investment and also an interest deduction on the debt that makes the investment possible. Given the expensing, the interest deduction is a mistake. Expensing, plus interest, gives a negative tax that is better than zero by about the value of the deduction of interest. The negative tax subsidy will cause waste of capital because it makes investments that are not acceptable in terms of their real pretax economics look acceptable to a taxpayer after tax.

The negative tax, moreover, is rate dependent giving more subsidy to high-bracket taxpayers than to low. A rate dependent subsidy is a terrible idea. It drives young entrepreneurs, startup companies and ailing companies out of the market simply because they have too low a tax bracket. A rate dependent tax bracket will also leave high-bracket investors with windfalls that they do not turn over to investment.

Separately, the NCRS proposal also needs to define NCRS property as not eligible for advantageous capital gains rates. Real estate needs to have "full" recapture and more. Deduction of inputs against ordinary income combined with favorable capital gains rates for outputs creates a separate rate dependent negative tax better than zero.

It is the combination of expensing and the interest deduction and the combination of expensing and the capital gains rates that are the killer issues. The combination is what needs to be corrected. Household ammonia is a pretty good cleaner. Chlorine bleach is a pretty good cleaner, too. But pour them in together in the bathtub and you will blow out your bathtub. The NCRS proposal didn't check its combinations.

The second error of NCRS is that it assumes without support, that savings will respond powerfully to expensing. Without a powerful savings response, the proposal just shifts the burden of tax off of taxpayers who have capital and on to taxpayers who have little or no capital. That shift will do the country harm.

We had our experiment with expensing in the 1981 enactment of ACRS. We need to learn from that experiment. ACRS was a supply side depreciation system, like NCRS, providing for expensing for machinery and equipment. The data from the experiment is in; ACRS failed. The 1981 act gave the largest incentives to capital in the history of income tax, and yet, savings declined after the act for good and solid reasons.

The consensus of the economics profession across the political spectrum from right, to middle, to left, is that the data gives no support to findings of high positive response or significant elasticity in response of savings to tax rate reductions. Proponents of ACRS were surprised. Congress cut back on ACRS in 1982, 1984, and 1986 because the incentives were too generous and did not work. We need to learn from our mistakes. ACRS failed. We cannot afford it again.

The third error of the NCRS proposal is in scoring the proposal as a revenue raiser, when it should be scored as a revenue loser more costly than expensing. NCRS is scored as a revenue raiser because it switches from 200 to 150 percent declining balance depreciation in its underlying structure. But NCRS then gives generous interest deductions, the "NCR ratio," intended to give NCRS a value like expensing.

But, because of the 5-year window convention, most of the interest costs of the NCR ratio are pushed beyond the 5-year window and ignored.

Scoring NCRS as a revenue raiser is dishonest accounting that hides the true cost. NCRS is intended to be the equivalent to expensing and its cost needs to be scored as equal to the cost of expensing.

If this kind of misleading accounting were done in the private sector to sell securities or consumer goods, the promoter should be indicted.

These three errors are explained in greater detail in my statement in full.

I thank you very much.

[The prepared statement follows:]

Statement, Three Errors in the "Neutral Cost Recovery System" Proposal

Professor Calvin H. Johnson*

Title II of the Contract-With-America bill, HR. 9, would allow taxpayers to elect a complicated new depreciation system, the neutral cost recovery system ("NCRS"), for basis in machinery and equipment. The logic of the system is that taxpayers should be given tax savings worth the value of "expensing" for tangible personal property with a current tax life of 10 years or less. "Expensing" means deducting the basis of one's investment immediately, as soon as the equipment is set up for use, although no resources have yet been lost. Under the NCRS proposal, the taxpayer in fact takes deductions over the tax life of the property, but NCRS then gives interest and inflation adjustments to compensate for the delay since the investment's start.

The NCRS proposal involves a number of serious errors, judged under neutral, professional standards. Left uncorrected, the errors make NCRS an irresponsible or ideological proposal. In the political excitement of the moment, it is too easy to let professional standards go by the way, but politics needs calm deliberation and dispassionate analysis. We need to slow down and correct these errors now or we will repent at leisure. The mistakes are, however, core errors so that correction might well kill the whole NCRS proposal.

(1) Tax Shelters. The first error of the NCRS proposal is creating negative taxes or subsidies by combining expensing with an interest deduction and with lower capital gains rates. The proposal, for instance, allows both expensing of the investment and also an interest deduction on debt that makes the investment possible. Given the expensing, the interest deduction is a mistake. Expensing and interest deduction gives a negative tax, better than zero tax by the value of deducting interest. The negative-tax subsidy will cause waste of capital by making investments that are not acceptable, in terms of their real pretax economics, look acceptable to the taxpayer after tax.

The negative tax is tax-rate dependent, moreover, giving more subsidy to high bracket taxpayers than to low. A bracket-dependent subsidy drives young entrepreneurs, start up companies and ailing companies out of the market, simply because they have too low a tax bracket. A bracket-dependent subsidy also leaves high bracket investors with windfalls they do not turn over to investment.

Separately, the NCRS proposal combines expensing with advantageous capital gain rates. Given expensing, favorable capital gains rates applied to any gain creates a separate rate-dependent, negative tax.

It is the combination of expensing and the interest deduction or capital gains rates that is the killer issue. Household ammonia is a pretty good cleaner, for instance, and chlorine bleach is a pretty good cleaner too, but pour them in together to clean the bathtub and you will blow out the bathtub. The NCRS proposal did not check its combinations.

2. Savings don't respond to incentives. The second error of NCRS is that it assumes, without support, that savings will respond significantly to expensing. Without a significant savings response, NCRS just shifts the burden of tax or deficit from taxpayers with capital to taxpayers with little or no capital. That shift will do the country harm.

We have had our experiment with expensing in the enactment of the Accelerated Cost Recovery System, "ACRS," in 1981. ACRS was, like NCRS, intended to allow expensing equivalence for machinery and equipment. The results of the experiment are in. ACRS failed. The 1981 Act gave the largest tax incentives for capital in the history of the income tax and savings declined. The consensus of the economics profession across the political spectrum is that the data gives no support for a significant positive response of savings to tax rate reductions. The proponents of ACRS were surprised. Congress cut back on ACRS in 1982, 1984 and 1986 because the incentives were too generous. We need to learn from our mistakes.

3. Revenue Estimates. The third error in the NCRS proposal is in scoring the proposal as a revenue raiser. NCRS is equivalent to expensing in intent and impact and scored like expensing, NCRS loses roughly $300 billion over five years. NCRS is scored as a revenue raiser because it switches from 200% to 150% declining balance depreciation in its underlying structure. But NCRS then gives interest and inflation adjustments, in the "NCR ratio," that compensates for the delay after expensing. Because of the 5-year window convention, however, most of the costs of the NCR ratio are pushed beyond the 5 year window and ignored.

Scoring NCRS as a revenue raiser is dishonest accounting that hides the true cost and impact on the deficit. If this kind of accounting were done in the private sector to sell securities or consumer goods, the promoter should be indicted.

Statement in detail: Three Errors Explained

1a. Negative Tax: Interest Deduction[1]

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[1] This section is based on Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply-Side Depreciation*, 61 TEX. L. REV. 1013 (1983), which has more extensive arguments on some issues.

NCRS permits expensing of the cost of the investment and also permits the taxpayer to deduct interest on debt financing that makes the investment possible. The combination of expensing and interest deduction means that there is a "negative tax" or subsidy on the investment, that is, treatment better than mere tax exemption or zero tax. The subsidy is generally worth the value of deducting interest.

Algebraic description. The negative tax or subsidy can be shown with simple algebra. Assume taxpayer Q borrows amount "B" paying interest of "i" to make an investment A in equipment that will return profit at return rate "r" annually. Assume first that interest, "i," and profit, "r," are equal, so that in absence of tax, investment A is a break-even investment. Every year for the life of the equipment, A makes $B*r$ profit and pays $B*i$ interest. $B*r-B*i=0$.

Adding tax, with both expensing and an interest deduction, will improve Q's return. With expensing of investments, taxpayer Q can expand the amount invested in A, relying on tax savings generated by the investment (at tax rate "t") to reduce its cost. With expensing, borrowing of B will allow Q to invest amount X such that $X-t*X = B$. Rearranging the algebraic terms, it follows that the amount invested X in investment A under expensing will be $B/(1-t)$. The expensing allows Q to get pretax return rate r on augmented investment, $B/(1-t)$, whereas Q pays interest only on borrowed B itself. The pretax position every year is

$$[B/(1-t)]*r - B*i \quad (1).$$

The pretax position in expression (1) is subject to tax at rate t, so that Q's after tax annual income is

$$[B/(1-t)]*r - B*i -t\{[B/(1-t)]*r - B*i\}, \quad (2).$$

which is equivalent to

$$(1-t)\{[B/(1-t)]*r - B*i\} \quad \text{or}$$

$$B*r-B*i + B*i*t. \quad (3)$$

When return rates and interest rates are the same, $B*r$ and $B*i$ cancel out and expression (3) becomes

$$B*i*t \quad (4).$$

Expression $B*i*t$ is an after tax positive value or subsidy equal to the tax saved by deducting interest of i on borrowing B for an investment in A that would have no net value ($r=i$) in absence of tax.

The subsidy, $B*i*t$, will allow taxpayers to accept real returns from investments that are materially below the prevailing cost of borrowed capital.

Setting after-tax annual return, expression (3), equal to zero :

$$B*r-B*i + B*i*t = 0 \quad (5)$$

Rearranging the terms and factoring out B:

$$r = i(1-t) \quad (6).$$

Hence with the subsidy, an investor will accept a pretax or real loss on the investment, which however will cover the cost. Going backwards to check, we can substitute low return $i(1-t)$ in expression (3) so that there is a pretax loss:

$$B*i*(1-t)-B*i \quad \text{or}$$

$$-B*i*t \quad (7)$$

But the tax subsidy $B*i*t$ (in bold in (8) below) will turn the pretax loss in an investment able to meet its cost of capital:

$$-B*i*t + \mathbf{B*i*t} = 0 \quad (8)$$

Ordinary use of NCRS with debt would be a paradigm tax shelter. A tax shelter is an investment that is worth more after tax than before tax because of negative tax from artificial accounting losses. A tax shelter saves the investor tax that would otherwise be paid on consumed amounts or other outside income. Within the parlance of HR 9, "neutral" means free from tax and, under that criterion, NCRS is not neutral because it goes beyond zero tax. To get back to zero tax, interest deductions must be disallowed or something equivalent, that offsets the $B*i*t$ subsidy.

The subsidy ($B*i*t$) will allow taxpayers in competition to bid up the price of investment A so that the return, r, stated as a percentage of investment, will drop below the prevailing interest rate, i, to $i(1-t)$. For instance, where pretax interest rates are at 7%, then the return to the highest bracket investors from the NCRS qualified investment needs only be 7%(1-41%) or 4%.

A tax system that allows investors to profit privately from investments that return less than the prevailing interest rates wastes capital. We saw the waste in the tax shelters prevailing before the 1986 Tax Reform Act. Investors put their money into legal, but economically silly investments such as see-through office buildings, garden apartments that were constructed and then promptly torn down, jojoba beans in Costa Rica, twaddling record masters and the like. We have too little capital to waste it so.

The waste will be most significant for situations outside of the passive activity restrictions, that is, for corporate investors and for investors who actively participate in the business making the investment, but the negative tax will have effect even within the limitations imposed by passive activity rules.[2] The proposal would limit NCRS deductions to the amount of the investor's business taxable income, but that limitation does not prevent use of the subsidy to zero out all business real income. Where the negative tax is available, the waste from returns below prevailing interest rates is as inevitable as apples falling.

Rate-dependent. The subsidy, $B*i*t$, also critically depends upon the investor's tax rate at which the value of expense and interest deductions are computed. High tax bracket investors, with the highest values for t, will get the largest subsidy -- perversely because they are considered to be the best bearers of tax. Lower bracket competitors such as start up companies, young entrepreneurs with fresh ideas and ailing companies temporarily in trouble will get lesser or no subsidies and will be driven out of the market. The following chart shows the interest cost, less the $B*i*t$ subsidy, equaling the required pretax return r, for various tax brackets:

Tax bracket (t) of investor	Interest cost (i)- 7%	less subsidy ($i*t$) on 7% interest	equals required real return (r)
41%	7%	2.9%	4.1%
34%	7%	2.4%	4.6%
28%	7%	2.0%	5.0%
15%	7%	1.05%	5.95%
0	7%	0	7%

As the chart shows, it is the highest bracket investors who can accept the lowest returns under the subsidy and will pay the most for any given property. For example when interest rates are 7%, a 41% bracket investor needs only a 4% return from the investment and a start up company facing no tax will need a 7% return. All other things being equal, high bracket investors will bid up the price of the investments, driving down r, and driving out lower bracket investors.

The $B*i*t$ subsidy would discriminate not only for rich against poor, but also, along geographical lines, in favor, of high income tax states. States with high rate income taxes, such as California and New York, that have tax systems that trace federal taxable income would give a higher subsidy than low rate states such as Texas and Nebraska. California and New York residents can thus outbid residents in low tax states in the auction for NCRS-qualified property. The geographical discrimination arises perversively because the negative tax subsidy depends upon the tax rate (the t in the $B*i*t$ subsidy) and is higher when the tax rate is higher.

Where the price for NCRS property settles will depend upon market factors, especially on how many alternative ways there are to avoid tax. The price will settle giving a return r at one effective tax rate, that of the marginal or last investor necessary to make all NCRS property sell. The required r (and price) will depend in the market upon the supply (basis that can be made to qualify within NCRS) and the demand (income that can not be sheltered from tax by cheaper means) for tax shelter. Because of the cornucopia of other tax advantaged plans that swamp the market,[3] we should expect the marginal rate to be less than the 34% statutory tax rate applied to large corporations.

Wherever the market settles, investors in a higher-than-the-marginal tax bracket will get a windfall that they do not turn over to investments. For example if the market settles with a pretax return of 5%, investors in the 41% and 34% bracket will get windfall returns in excess of their cost of capital. The 41% bracket investor will get 5% after tax whereas 4% would be a sufficient return to meet their cost of capital. The extra 1% windfall is a variety of waste.

Investors at or above the marginal rate will also become the exclusive owners of NCRS property. Unless they have some material nontax advantages, investors in tax brackets less than the marginal return rate will be excluded from the market because the return rate r is too low. Assuming again the market settles with a pretax return of 5%, then 15% and tax exempt or tax loss entities will not be able to afford the cost of capital and will not be able to buy the machinery.

It is difficult to see how the negative tax subsidy, $B*i*t$, can be anything other than an error. The rhetoric behind NCRS argues for zero effective tax rates, but not for a negative tax

[2] Section 469 of the Code provides that deductions from any passive activity may be used only against taxable income from all passive activities. Widely held corporations and active participants in a business are exempt from the limitations. Even for non-exempt taxpayers, deductions representing artificial accounting losses can be used against consumed amounts or other cash income. The passive activity rules are also under constant political assault, in part, because they represent such bad theory. There is nothing wrong with being passive nor with being active nor with the combination. The assumption behind the exemptions that businessmen and public corporations would not use artificial deductions is also nonsense.

[3] Harvey Galper & Gene Steuerle, *Tax Incentives for Savings*, 3 STATISTICS OF INCOME BULL. 1, 4 (Spring 1984) estimate that 80% of the assets held in wealth of individuals has an effective tax rate of zero, which implies that no high bracket taxpayer would accept very much lower r from NCRS investments.

subsidy. If we were going to give a subsidy for investment as a budget item with a known cost, we would not give the subsidy to the nonmeritorious drivel like jojoba beans and record masters that have qualified for the shelter subsidy in the past. We would also not distribute the subsidy in a way that would drive start up competitors and temporarily losing companies out of the market and we would not give the greatest subsidy to the richest first, in the exact negation of the pattern by which the tax burden is distributed, when Congress thinks about distribution issues and reaches a fair compromise.

The negative tax for debt financed NCRS investments is not justified by consumption tax arguments. Expensing has been supported by the consumption tax argument that an income tax is a double tax on capital,[4] but the debt-financed investment is missing the starting step of the double tax.. One can not defend the negative tax as a subsidy for capital formation since neither borrowing cash nor promising to pay for property in the future is capital formed, but instead is anti-capital or use of capital. Consumption tax theorists would correct the error of the negative tax by disallowing the interest deduction, taxing borrowed amounts or some equivalent measure.[5]

Interest on debt is in theory taxed to the other side, and if debtor and creditor were in the same bracket and paid tax as interest is deducted, there would be just zero tax. But investors arrange themselves into clienteles under which high bracket investors incur debt and pension funds or low bracket investors supply debt, so that only trivial tax is collected on interest. The market for interest, in any event, gives little or no premium to cover tax. Even if the creditors did pay tax on interest and pass it back to borrowers, that would raise the interest rates, but still leave a tax-dependent subsidy on the debtor's side, that would give windfall to some and exclude others just because of their tax bracket.[6] The combination of expensing and interest deduction is a mistake.

Remedy The remedy to bring tax up to zero is to disallow deduction of interest on debt, up to an amount of debt equaling the consolidated group's NCRS investment. It is neither administrable nor fair to attempt to "trace" debt to specific uses. Money is fungible. Financing from any source goes into a common pool from which the company needs are withdrawn. Debt incurred for any purpose will allow the taxpayer to increase NCRS basis, even if the occasion for the debt was not NCRS investment. Two taxpayers with identical balance sheets should pay the same tax, without regard to the order or occasion of their borrowing.[7] The necessary remedy follows IRC §263A(f) (construction interest) and identifies interest on the taxpayer's first debt as nondeductible. In theory interest should be disallowed on an amount of debt equal to the current value of NCRS. A less complete solution would be to identify the target debt according to the basis of NCRS property under a slow, economic depreciation schedule.

1b. Negative Tax: Capital Gain. Negative tax subsidies also arise on NCRS property because some part of the return from sale of the property would be eligible for lower-rate capital gains tax. As a matter of well established tax theory, expensing of an investment is equivalent to zero tax on the return from the investment. With expensing, taxes do not reduce the pretax percentage return the investor gets.[8] When expensing of the investment is combined with advantageous capital gain, tax *increases* the taxpayer's return from the investment.

> *Illustrations: Expensing*. Expensing does not reduce the taxpayer's return. Assume for instance an investment with $100 input and $131.08 revenue in four years. In absence of tax, the investment has a return ("internal rate of return")[9] like compound annual interest at 7%, because $100 will grow to equal $131.08 in four years at 7% compounded annually:
>
> $$\$100 \cdot (1+7\%)^4 = \$131.08 \qquad (9)$$

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[4] See, e.g., Norman Ture (later Assistant Secretary of the Treasury for Tax Policy urging ACRS), *Statement*, 1 GENERAL TAX REFORM: PANEL DISCUSSIONS BEF. COMM. ON WAYS & MEANS, 93d Cong., 1st Sess. 160,162 (1973)(benefits for depreciation just reduce the double tax on savings)

[5] David Bradford, *The Economics of Tax Policy Toward Savings*, in THE GOVERNMENT AND CAPITAL FORMATION 42-50 (George Von Furstenberg ed. 1980)(disallowing interest). Other advocates of consumption tax would cure negative tax by including borrowing in taxable income. DEP'T. OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 124 (1975); Nicholas Kaldor, *Comment*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURES? 151 (Joe Pechman ed. 1980).

[6] See discussion, Johnson, *Tax Shelter Gain*, 61 TEX. L. REV. 1013, at 1039-1049 (1983)

[7] See William Klein, 1962 WISC. L. REV. 608, 611-612.

[8] The thesis that expensing is the same as no effective tax on the percentage income from an investment is one of the base theorems of modern tax economics. See, e.g., See, e.g. Cary Brown, Business-Income Taxation and Investment Incentives, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300 (1948); DEPT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 123-24 (1977).

[9] "Internal Rate of Return" is the interest-like return on an investment, used as yardstick of worth. It needs to be modified to avoid some pitfalls, not however present here. See, e.g. Higgins, FINANCIAL MANAGEMENT: THEORY AND PRACTICE 47 (1977).

Rearranging equation (9), 7% is also the discount rate that will make the present value of the revenue on termination equal the present value of the cost:

$$-\$100 + \$131.08/(1+7\%)^4 = 0. \qquad (10)$$

Expensing the $100 input immediately means that the taxpayer gets a tax savings (here assumed to be at 40% tax rates) which reduces its cost (by 40%). When tax is imposed on the revenue at the same tax rate, the net result is that the taxpayer's return is not reduced by tax:

$$-\$100(1-40\%) + \$131.08(1-40\%)/(1+7\%)^4 = 0. \qquad (11)$$

Expression (11) is an illustration of the thesis that expensing is like a zero tax on the percentage return. The investment gives 7% return both before and after tax.

No recapture. The most dramatic negative tax occurs for investments like timber, business intangibles and R&D where there is no recapture and the entire return can qualify as capital gain. Assume no recapture and capital gains tax rates of 20% (half the assumed ordinary tax rate). All of the $131.08 received at the end of the investment is then capital gain, reduced by 1-20% to $104.86. The investment now has an annual return of 15% because 15% is the discount rate that makes the net present value equal zero:

$$-\$100(1-40\%) + \$131.08*(1-20\%)/(1+15\%)^4 = 0. \qquad (12)$$

Expensing of the input combined with capital gain for the output has *increased* the return from a pretax 7% to a post-tax 15%.

Expensing plus capital gain would also allow inferior investments to compete with better ones, post tax. Assume an investment that is a guaranteed money loser, requiring an input of $100 and giving a return of only $88.31. Nonetheless the investment gives 4.2% return after tax, which equals 7%(1-40%) or exactly what a 40% bracket taxpayer will get at the given prevailing interest rates on normally taxed bonds or CDs:

$$-\$100(1-40\%) + \$88.31*(1-20\%)/[1+7\%(1-40\%)]^4 = 0 \qquad (13)$$

Without recapture, expensing will cause wasted capital by turning investments that lose money on their economic merits ($100 to $88.31) into investments that are acceptable to taxpayers who get the subsidy.

Some capital gain. Traditional "full" recapture remedies have been limited to making only gain up to the original cost basis ($100) ordinary income and the NCRS proposal does not increase recapture. Under such recapture, for the 7% investment of $100 in and $131.08 out, the revenue output up to $100 would be subject to ordinary tax of 40% at termination, but the extra $31.08 "gain" would be subject to tax at 20%. The regime *increases* the return from 7% pretax to 9% after tax:

$$-\$100(1-40\%) + [\$100*(1-40\%)+\$31.08(1-20\%)]/(1+9.05\%)^4 = 0 \qquad (14)$$

A tax regime that increases the taxpayer's return after tax will also waste capital because it will make inferior investments acceptable after tax. The following investment gives only a 3.2% return before tax, because it grows only from $100 to $113.42 in four years.[10] But to a 40% bracket taxpayer, the 3.2% return will look as good as the prevailing 7% return:

$$-\$100(1-40\%) + [\$100*(1-40\%)+\$13.41(1-20\%)]/[1+7\%(1-40\%)]^4 = 0 \qquad (15)$$

A tax regime that makes a pretax 3.2% investments look as good as a pretax 7% investment will cause waste of capital.

To prevent negative tax, all gain from NCRS property must be ordinary income.[11] An incomplete solution, which would prevent some but not all negative tax, would be to provide that recaptured depreciation deductions are increased by 3.5% interest compounded, just as the NCR ratio increases the depreciation deduction by 3.5% interest.

2. The Failure of Expensing Incentives.

The second error in the NCRS proposal is its assumption that savings will increase significantly in response to expensing. The underlying purpose of NCRS is to provide an incentive for the formation of capital. The increased capital is to increase productivity and economic growth and to create more jobs. Unless savings responds significantly to the exemption, however, expensing of investment will just shift the burden of tax or deficit from taxpayers who have capital to taxpayers with little or no capital. Without increased savings, there will be no added capital to justify the shift in burdens downward, nor will there be added growth, increased productivity or

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10 $\$100 * (1.032)^4 = \$113.42$

11 NCRS property, however, must continue to be subject to the limitation on capital losses, which have a different rationale. See, e.g., Johnson, *Deferring Losses with an Expanded §1211*, 48 TAX L. REV. 719 (1993)

new jobs. Shifting the burden of tax or deficit downward onto the low capital taxpayers, who start with a lower standard of living, will do the country harm.

The assumption that savings will respond significantly to expensing has no support in the economic literature or the underlying economic data. If economics is a science, it is a science because it is empirical, that is, it tries to disprove its assumptions on the basis of the evidence. We need to look at the record.

We have had our grand experiment with allowing expensing of machinery and equipment and the results of the experiment are in. In 1981, in the enthusiasm at the start of the Reagan Administration, Congress adopted a tax system for depreciable property, the Accelerated Cost Recovery System ("ACRS"), intended like NCRS, to give the equivalent of expensing for machinery and equipment. ACRS reached for expensing-equivalence by giving an immediate 10% investment tax credit, whereas NCRS would reach expensing by giving an interest-like augmentation to deductions. ACRS in 1981 even went considerably beyond expensing in value because the computation of expensing-equivalence ACRS used an interest rate that was materially higher than the real interest rate the government must pay.[12] The purpose of ACRS, like that of NCRS, was to give incentive to capital formation, i.e., to savings.[13]

Proponents of ACRS in 1981 argued that savings would respond dramatically to the new incentive. ACRS was part of the "supply-side economics revolution" which sought to shift the focus of public policy away from fiscal stimulus, through government spending and deficits, and onto incentives for the production of goods.[14] Some proponents argued that the economic response to tax cuts might be large enough to make the 1981 tax cuts self-financing. The Laffer Curve, for instance, showed a range where economic response to tax cuts would be so extraordinary that the government revenue would rise by participating in the new higher level of economic activity.[15] More moderate advocates doubted a response that was self financing, but they did assume a high response,[16] arguing that the "elasticity of savings in response to the real after-tax rate of return was relatively large and elastic."[17]

Judged on its own terms, ACRS was a failure. Savings rates declined, notwithstanding the most dramatic cut in tax rates on capital in history. Personal savings, for instance, dropped from 7.9% of disposable personal income in 1980 to 6.4% of disposable personal income in 1985, to 4.2 % of disposable income in 1990.[18] Supply-side economics renounces deficit stimulus,[19] but the

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[12] ACRS, as adopted in 1981, was equivalent to expensing for corporations (46% bracket) at a 24% pretax interest rate. See Johnson, *Tax Shelter Gain*, 61 TEX. L. REV. 1013, 1022 n. 46(1983) (equating expensing and ACRS at 13.1% after tax which translates into 24% pretax interest at 46% tax rate). Even long term federal bonds in 1981 gave only 13-14% interest. COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT 1993, at 428.

[13] See Pamela Gann, *Neutral Taxation of Capital Income: An Achievable Goal?* LAW & CONTEMP. PROBS., Autumn 1985, at 77,97-108(giving overview of arguments for capital formation).

[14] See Paul Craig Roberts, *Supply-Side Economics*, in 4 NEW PALSGRAFFS ECONOMIC DICTIONARY 615 (1987).

[15] Jude Wanniski, *Taxes, Revenues and the 'Laffer Curve"*, PUBLIC INTEREST, Winter 1978, at 3 *reprinted in* Arthur Laffer & Jan Seymour (ed.), ECONOMICS OF THE TAX REVOLT 7 (1979). See also Arthur Laffer, *Statement*, THE ECONOMICS OF THE PRESIDENT'S PROPOSED ENERGY POLICIES: HEARINGS BEFORE THE JOINT ECONOMIC COMMITTEE, 99th Cong., 1st Sess. 16, 18 (1977)("[I]t is not only conceivable but entirely possible that [the proposed 2.8 billion tax !] will lead to reduced overall revenue... .").

[16] Don Fullerton, *On the Possibility of An Inverse Relationship Between Tax Rates and Government Revenues*, 19 J. OF PUB. ECON. 3 (1981), concentrating on labor responses, found it possible but unlikely that total revenues would increase. Donald Keifer (Library of Congress, Congressional Research Services), *An Economic Analysis of the Kemp/Roth Tax Cut bill H.R. 8333, CONG. REC.* Aug. 2, 1978, H7777-7787, using privately developed economic models with an aggressive supply-side orientation, nonetheless, projected nothing close to elasticity of one percent saving increase per one percent tax decrease. Paul Craig Roberts, an important supply-side advocate argues that self-financing was never the goal, but he made the argument only after it was clear that self-financing did not happen. *Supply-Side Economics, supra* note 14.

[17] Mai Nguyen Woo (Research Associate IRET), *Taxation, Savings, and Labor Supply: Theory and Evidence of Distortions* in ESSAYS IN SUPPLY SIDE ECONOMICS 117, 131 (David G. Raboy ed. 1982). Similarly Michael Boskin, who became Reagan's Chairman of the Council of Economic Advisor's found a significant positive response (0.4 elasticity) by savings to after tax interest, 5 *Taxation, Saving, and the Rate of Interest*, 86 J. OF POL. ECON. S3 (1978), but see Lans Bovenberg, *Tax Policy and National Saving in the United States: A Survey*, 42 NAT. TAX J. 123129 (1989)("others have found it difficult to reproduce his results."); Robert Hall (Hoover Institute), *infra* note 23 (findings that consumers save when expected interest rises are in error) and other sources cited, *infra* notes 18-27.

[18] DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES, 1994 No. 695 (drawing from BEA, National Income and Product Accounts). Personal savings remained low at 4.0% of disposable personal income in 1993.

[19] See, e.g., Paul Craig Roberts, *Supply-Side Economics, supra* note 14, at 615.

annual deficit, projected to disappear in the last federal budget before the 1981 Act,[20] in fact grew in size from $74 billion in 1980 to $220 billion. by 1986.[21] Proponents of ACRS were surprised, even shocked. Norman Ture, one of the primary architects of ACRS as a Treasury official in 1981 was quoted as saying that the drop in savings is "not only a disturbing result, ... it is very surprising."[22]

On terms not allowed by Reaganomics, the deficit created by ACRS caused a fiscal stimulus to the economy. The fiscal stimulus of deficit spending created economic activity and made every one riding upward feel good. The high deficits, however, were the target or enemy of supply-side depreciation, not its purpose. President Reagan had promised that "we are putting the false prosperity of overspending, easy credit, depreciating money and financial excesses behind us.[23] Thus the benefits of the ACRS deficits can not count to its credit.

The conclusion that investable savings did not increase elastically in reaction to the 1981 incentives is a strong consensus shared by the economics profession across the political spectrum. Robert Hall of the conservative Hoover Institute, for instance, has concluded that consumers do not defer consumption in response to expected interest returns and that apparent findings to the contrary were in error.[24] Joel Slemrod of the respected National Bureau of Economic Research and the University of Michigan and the editor-in-chief of the National Tax Journal tells us that the economic research from the 1980s has concluded that savings are unresponsive to lower tax.[25] Tanzi and Sheshinski of the International Monetary Fund have found that there was no important increase in U.S. savings rates after ACRS.[26] Jonathan Skinner and Daniel Feenberg of the National Bureau of Economic Research report that the consensus in the economic literature is that any positive response of savings to interest rate increase is "fragile and fleeting." Long-term, since the 1970's, they find, savings have reacted negatively to increase in after tax returns.[27] Barry Bosworth and Gary Burtless of the Brookings Institution show the decline of different kinds of private savings throughout the 1980s and advise that "government policy-makers should act under the presumption that income tax incentives for saving are likely to fail."[28]

Tax incentives do have a powerful influence on the timing, form and channelling of investment, but those effects do more harm than good. Taxpayers, for instance, delay or anticipate sales to take advantage of shifts in capital gains rates.[29] Taxpayers will also rapidly change the legal or financial forms by which investment is undertaken. In 1986, for instance, Congress changed the relation of corporate and individual tax rates S Corporations became better investment vehicles than regular C corporations.[30] Corporations responded dramatically, scrambling to make S elections.[31] Finally, taxpayers will move around fixed capital already in existence to achieve tax

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[20] OFFICE OF MANAGEMENT AND BUDGET ("OMB"), U.S. BUDGET, FISCAL YEAR 1982, M3 (1981)(projection for 1984).

[21] DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES, 1994 Table No. 505

[22] Kilborn, *Americans Saving Less Now Than Before the 1981 Act*, NEW YORK TIMES, Sept. 6, 1983 at A1, col. 3.

[23] Budget Message of the President, US.BUDGET, FISCAL YEAR 1983 at M5. See also Paul Craig Roberts, *Supply-Side Economics, supra* note 14, at 615.

[24] Robert Hall (Hoover Institute) *Intertemporal Substitution in Consumption*, 96 J. OF POL. ECON. 339, 350 (1988)

[25] Joel Slemrod, *Do Taxes Matter? Lessons from the 1980's*, 82 AM. ECON. REV. 250, 251-252 (1992)

[26] Tanzi & Sheshinski, *Fund Study Suggest Answer to the U.S. Savings Puzzle*, 13 IMF SURV. 353, 366-67 (1984).

[27] Jonathan Skinner & Daniel Feenberg, *The Impact of the 1986 Tax Reform Act on Personal Saving*, NBER WORKING PAPER NO. 3257 at 10-17 (1990)

[28] Bosworth and Burtless, *Effects of Tax Reform on Labor Supply, Investment and Saving*, 6 J. OF ECON. PERSPECTIVES 3, 14-23 (1992).

[29] Alan J. Auerbach, *Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, 1988- 2, 595, 627(change in capital gains rates in 1986 had a strong impact on the timing of sale); Fredland, Gray and Sunley, *The Six Month Holding Period for Capital Gains: An Empirical Analysis of its Effect on the Timing of Gains*, 21 NAT. TAX J. 467, 471 (1968)(investors sell property in the month after meeting the holding period requirements for capital gain at a rate that was eight times the rate of sales in the month before qualifying for the preferential rates).

[30] The terminal value of a $1 investment in a partnership, sub S corporation or C corporation debt is $[1+R(1-t_p)]^n$ and the terminal value of a $1 investment in equity of a corporation, terminated by a capital gain transaction. is $[1+R(1-t_c)]^n - cg \cdot \{[1+R(1-t_c)]^n-1\}$, where R is the prevailing pretax return on capital, n is the years until termination of the investment and t_p t_c, and cg are the maximum tax rates on individuals, corporations and capital gain respectively. Myron Scholes & Mark Wolfsen, TAX AND BUSINESS STRATEGY 57-59 (1992) Prior to 1986 with R=10%, n = 25, t_p = 50%, t_c = 46%, and cg = 20%, the partnership, debt or subS would give $2.65 per dollar invested and the C corporation stock would give $3.18. After 1986, with t_p = 33%, t_c = 34%, cg = 28% and R and n the same, the partnership form would give income of $5.05 and the C corporation stock would give $3.83.

[31] Robert Leonard, *A Pragmatic View of Corporate Integration*, 35 TAX NOTES 889, 895-90 (1987)(In first 2 weeks of 1987 there were 220,000 subchapter S elections, compared with 70,000 elections for all of 1985).

savings. When IRA's and Keogh plans were liberalized in 1981, taxpayers reacted far more dramatically than expected, but apparently without however increasing their total savings.[32] Movement in the form or direction of savings does not increase over-all capital and will usually cause waste by inducing the use of the fixed savings in inferior investments. Tax incentives can affect channelling, short-term shuffling and financial manipulations, but they will not cause capital formation nor improve the efficiency of its use. The hard thing to do is to increase real savings and underlying savings did not respond to the 1981 incentives.

Explaining negative and sluggish reactions. The results from the data that underlying savings react sluggishly or negatively to tax cuts is plausible in terms of normal economic behavior, even if it seems implausible at first. Savings drop when taxes go down, first, because of "target savers" who quit saving earlier when their after-tax return rate increase. Assume, for instance, that Saver A needs $150,000 for tuition payments in 10 years for his child. When after-tax return rates are 12% after-tax, A must set aside $8,548 a year for 10 years. Reduce A's return to 3% after tax and A will need $13,085 per year. Take away the difference (9%) in tax and watch A get really desperate and also increase savings by $4,500 per year per child to meet his targets. Taxpayers who are saving for a car or downpayment on a house or retirement security are similarly target savers who will *contract* savings rates when after tax returns on saving go up and increase savings when tax rates go down..

Decreased taxes decrease savings, secondly, by reason of what has been called the "mail-box effect,"[33] that is, taxpayers consume a high proportion of cash received. Under traditional theory -- the permanent income theory—, rational, far-sighted consumers should average their resources evenly over their life times. They should not increase consumption simply because more cash is realized, unless the cash also signals a real increase in wealth or the permanent flow of income.[34] Under the model, cash is no reason to increase consumption.[35] But econometricians are finding increasing evidence that consumers are not very far sighted in their savings behavior. Consumption is closely related to receipts, averaged over a time horizon of just a few years, and it is more volatile than allowed by life-cycle model. Consumers keep only enough savings to buffer uncertain incomes in the next few years and they consume the rest.[36] Under these findings, a tax cut increases consumption because it increases the cash that consumers have in hand.

The sluggish response of capital formation to tax incentives also occurs because so much of savings goes forward even when real interest rates are negative. Much saving is done to create a buffer or to average out consumption. Money that you have for subsistence in case of trouble is very much more valuable than money spent on luxuries during good times. It is thus rational to save money for a rainy day, even if the return rates are negative. Pharaoh had a dream that Joseph said meant Egypt would have 7 fat years and then 7 drought years. Joseph said save. Mice ate the grain so that it shrank by 10%-15% per year, so that the real rate of interest on stored grain was a negative 10-15%. Still, Joseph was no dummy. The rationality of saving, even in the face of expected negative interest rates also explains, for instance, why in high-inflation Latin American countries, the wealthy often save in dollars. Dollars give no interest coupon and dollars do lose value, although not the rate of the local currency. Saving goes on.

The rationality of saving, even in the face of negative interest rates, suggests that much of positive after-tax interest rates that savers in fact receive is "rent," that is, an amount in excess of

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[32] Eric Engen, William Gale & John Karl Scholz, *Do Saving Incentives Work?* BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1994-1, 85, 150.

[33] Douglas Bernheim, Introduction in NATIONAL SAVINGS AND ECONOMIC PERFORMANCE 1,5 (Douglas. Bernheim and John Shoven ed. 1991).

[34] A rational far-sighted consumer should smooth his consumption so that his expected lifetime wealth is consumed at steady, average rate over his whole life. Wide variations in amount consumed per year will not maximize utility of the dollars spent. Franco Modigliani, *The Life-cycle Hypothesis of Saving, the Demand for Wealth and the Supply of Capital*, 33 SOCIAL RESEARCH 160 (1966).

[35] Auerbach & Hassett, *Corporate Savings and Shareholder Consumption, In* NATIONAL SAVINGS AND ECONOMIC PERFORMANCE 75 (Douglas. Bernhein & John. Shoven ed. 1991)

[36] Barry Bosworth, Gary Burtless & John Sabelhaus, *The Decline in Saving: Evidence from Household Surveys*, BROOKINGS PAPERS ON ECON. ACTIVITY, 1991-1, 226 (summarizing the research);. Christopher Carroll and Larry Summers, *Consumption Growth Parallels Income Growth: Some New Evidence*, NBER WORKING PAPER, No. 3090 (1989)(permanent income or life-cycle hypothesis is inconsistent with the grossest features of the data on actual consumption patterns); Flavin, *The Adjustment of Consumption to Changing Expectations about Future Income*, 89 J. OF POL. ECON. 974, 1006 (1981)(data rejection of the permanent income or life-cycle hypothesis is significant); Campbell and Mankiw, *Permanent Income, Current Income, and Consumption*, NBER WORKING PAPER NO. 2436, 32 (1987)(estimating that 40-50% of income is received by individuals who consume according to current income rather than according to wealth or permanent income.)

the strike price necessary to induce the savings. The interest can be reduced by tax to the negative range, even by increasing tax on capital, without much effect on such savings.[37]

3. Revenue Estimates

The third error in the NCRS proposal is in scoring the proposal as gaining revenue for the government. NCRS is intended to be equivalent to expensing in net present value terms and cost to the government. It is misleading accounting to score NCRS with a revenue estimate loss less than what would be scored for expensing. Scored honestly, I estimate that NCRS will lose over $300 billion over the five year budget window.

Under the Budget Act, revenue estimates are prepared for tax proposals by the staff of the Joint Committee on Taxation to analyze how a tax proposal will affect federal deficits.[38] The federal deficits are large enough now that no one would wish them larger. Revenue estimates limit how much can be given away by competing tax proposals.

In substance, the NCRS proposal treats the federal government as owing an obligation at the time and amount determined by expensing and requires the government to pay interest on the obligation by increasing annual deductions. In fact, NCRS gives taxpayers deductions over the tax life of the property under the pattern of 150% declining balance method of depreciation,[39] but the proposal increases the annual deductions by a compound interest factor, the "NCR ratio," to compensate the taxpayer for the delay since the property was placed in service. The NCR ratio augments the annual deduction to cover both inflation, now at 3.2%, and an after-inflation 3.5% interest amount. The two adjustments mean an annual interest factor of 3.5%+3.2% or 6.7%, or slightly higher than the current 6% federal interest costs on short-term federal obligations, in which the obligee is similarly protected from rises in inflation.

Since NCRS treats the government as owing an interest-bearing debt equivalent to expensing, the revenue cost from NCRS should be scored as the equivalent of the revenue loss from expensing. In analyzing the distributional impact of the burden of proposed tax changes, the staff of the Joint Committee on Taxation has adopted a principle to maintain consistency in the measurement of "tax proposals that are expected to have equivalent economic effects on the taxpayer."[40] It is, for instance, possible to create a zero effective rate on pension fund investments either by excluding contributions from tax or by excluding distributions from tax and the present value of either alternative would be the same. The Staff analyzes both as having the same economic impact, although in the former case the tax benefits are front-end loaded and in the latter they are back-end loaded. That principle applied to revenue estimating would mean that NCRS would be scored the same as its intended equivalent, expensing. Using available data, I estimate that NCRS would lose over $300 billion during the next five years if NCRS were scored as an expensing-equivalent.[41]

Because of an artificial five-year convention in revenue estimating,[42] however, NCRS is in fact scored as if it were a revenue raiser. Current law allows depreciation deduction under the 200% declining balance method and switching to 150% declining balance means more undiscounted revenue for 5 years, even with the augmentation by the NCR ratio. Most of the costs

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[37] The premium return or "rent" on savings means, by definition, that the rent or premium could be taxed away without changing the amount saved. The maximum revenue from capital (as shown for instance in the Laffer Curve) should be at a point in which after-tax interest is negative. Labor income, by contrast, could never be taxed into the negative range without suppressing the income in full. The rationality of savings even in the face of negative returns suggests that there might be efficiency gains possible by shifting taxes from labor and onto capital

[38] See Joint Committee on Taxation, *Discussion of Revenue Estimation Methodology and Process* (JCS 14-92)(Aug. 13, 1992).

[39] The 150% declining balance method of depreciation first computes what fraction of basis would be allowed in the first year if basis were allowed in equal portions in each year of the tax life. (e.g. $1/n$, where n is the tax life). It then increase the fraction by 150%to $1.5/n$. The fraction $1.5/n$ is multiplied by the remaining or adjusted basis from the end of the prior year to determines the depreciation deduction for the current year. A constant percentage of an every decreasing adjusted basis would never allow the taxpayer to recover the entire basis, so the taxpayer is allowed to deducting remaining basis in equal amounts over the remaining years when that amount is bigger ($1.5/n \leq 1/m$ where m is remaining years of the tax life).

[40] STAFF OF THE JT. COMM. ON TAXATION, METHODOLOGY AND ISSUES MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 4 (JCS 7-93)(July 14, 1993).

[41] I reach an estimate of revenue loss of roughly $330 billion composed of $775 billion revenue cost from expensing, less $445 billion loss from depreciation under current IRC §168. My estimates assumes $3.1 trillion investment in NCRS eligible property in 1995-1999, assuming Producer Durable Equipment of $528 billion in 1994 extrapolated forward at 5.4% annual growth. BUREAU OF ECONOMIC ANALYSIS, SURVEY OF CURRENT BUSINESS 3 (Nov. 1994)) and a 25% average tax rate for users. My rough estimates can not be expected to correspond to Joint Committee, Congressional Budget Office or Treasury figures, which start from a different data base that better decribes NCRS investment..

[42] The 5 year window is a mandate of the Congressional Budget Act (Joint Committee on Taxation, *supra* note 38 at 3), but that mandate does make the accounting any less misleading or the costs less hidden.

of the NCR-ratio interest factor occur beyond the five year window. Revenue costs that occur after five years are ignored.

Scoring NCRS as a revenue raiser is misleading, dishonest accounting that hides the true cost. NCRS will not decrease the deficit or federal debt, as it is scored. NCRS will increase the federal debt by the roughly $300 billion over five years. A public policy is responsible only if it measures the costs of a proposal and compares the costs fairly and forthrightly with the benefits. If the costs are hidden or ignored, then the costs and benefits can not responsibly be compared. The hiding of costs by pushing costs to beyond the five year window will distort decision-making. Unfortunately, the first victim to be misled will be Congress itself.

Mr. HERGER. Thank you, Mr. Johnson.

Mr. Kachadurian, if you could elaborate a bit more, if you would, on how the capital gains provisions in the Contract With America will help ease the exit tax problem you described in your testimony.

Mr. KACHADURIAN. Mr. Chairman, the exit tax comes about when there are certainly at least very low or, even in some cases, negative capital accounts carried by partnerships that own real estate. We see this quite a lot when we are trying to acquire real estate and the seller or owner of that real estate has a capital account whereby in order to first pay off the existing loan, and then also settle up on a basis that is at least zero, and sometimes negative because of previous losses that have been taken, the property effectively cannot be sold because there is not cash available from the sale to pay the taxes. So the property is frozen, in effect.

And we have seen property after property that is frozen without money or capital being reinvested in that property to improve the property and so the rent roll tends to suffer. I think, in many cases, as we have been told, the only alternative is really death to the owner of that property where the basis can finally be stepped up, which we don't think is a solution to creating better real estate and better income streams.

Mr. HERGER. Mr. Didion, in your testimony you discussed the cost recovery rules for leasehold improvements. If the committee were to consider alternatives to the neutral cost recovery proposal, as some have suggested today, would changes to the treatment of leasehold improvements be appropriate?

Mr. DIDION. Mr. Chairman, we believe that would be absolutely appropriate. We think leasehold improvements need to have a change in the tax treatment in terms of the life of the improvements, and we believe that that change will in fact incent the job creation and urban reinvestment, so we believe there are lots of benefits to it.

Mr. HERGER. Thank you very much.

Mr. McDermott will inquire.

Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. I must tell you that as you all were testifying, I was thinking that in 1986 when I was a real estate professional and was testifying before the Senate Finance Committee about the 1986 Tax Act, many of the things that you are talking about and saying here today were things that we expressed concern about in 1986. So I feel to some extent that the chickens have come home to roost, I suppose.

I did want just to pursue one element, and that is the element of unlocking of capital gains, and there are differences of opinion about how much of that might occur if in fact there is a capital gains reduction. If each of you might share with this committee either data that you have or any anecdotal information that you might have, it may be certainly helpful as we think about this particular element of assessing the impact of the capital gains tax, and I would start maybe with Mr. Woods.

Mr. WOODS. Well, one of the things, Congressman Payne, is that certainly, as I mentioned in the report, there are literally—no, I was going to say thousands, but tens of thousands of small investors out there that have been frozen into property because they just aren't willing to or they aren't able to pay the tax that they would have to pay to get out of it.

With this bill, with the passage of this bill and cutting that rate in half, I think that you would see many, many more properties on the market that people just are refusing to put on the market right now. So it is a situation where, yeah, you are going to get half the tax revenue that you would get if they sold today, but in reality they are not going to sell today, so the government really ends up with 50 percent more than they would have otherwise, but it is 100 percent more than they would get if they didn't change the tax laws.

Mr. PAYNE. And you would say today that compared to——

Mr. WOODS. Anytime since the tax changes of 1986 that you were speaking of.

Mr. PAYNE. That there would be more potential for unlocking than anytime since 1986?

Mr. WOODS. That is right. You have a vast sum of properties that have just been locked up tighter than a drum since the elimination, the slow elimination of capital gains in the late eighties.

Mr PAYNE. Mr. Kachadurian.

Mr. KACHADURIAN. Mr. Payne, I couldn't agree more with Mr. Woods. I think he probably said everything I would have said, and the answer to Mr. Herger's question that I gave before really summed up my feelings in that there is a lockup of these same properties that we see that aren't being sold, the transactions aren't occurring, and second, the unlocking of these transactions will stimulate job growth because as these properties are sold and capital flow begins to increase, we will see the same carpenters, laborers, appliancemakers improving, in our case, apartment units that are in need of improvements, and as these units are improved, the rent rolls improve, and these buildings come back to the same place they were when they were built.

Mr. PAYNE. Thank you.

Mr. Didion.

Mr. DIDION. Congressman, I agree with both the previous speakers on this.

Mr. PAYNE. Mr. Freeman.

Mr. FREEMAN. Congressman Payne, I think our strongest international competitors, such as Japan and Germany, both see fit to not even have a capital gains tax or a very small one.

That is simply to bolster the advantages of capital seeking its highest and best use. Clearly in our country now we are seeing sales and movement of capital not taking place because up to a third of the capital is going to disappear due to this tax upon sale, and it takes a pretty good alternative investment to talk you into taking that kind of a licking and reinvest the remaining two-thirds into that. It is such a differential in return in order to motivate you to move that people just don't do it.

Mr. PAYNE. Not only a differential, but, as Mr. Kachadurian pointed out, there are probably assets in shopping centers that are frozen because of the current situation and the negative basis that people might have to deal with. Consequently, they couldn't get enough cash to pay both their debt and to be able to pay their taxes in order to sell some of these marginal properties.

Is that a fair statement?

Mr. FREEMAN. I think so. As you know from being in the business yourself, a loan today requires equity, and that is probably a much healthier way for us to restructure, too, and this is capital that is equity and it is hard to find sometimes because of this lock-in.

Mr. PAYNE. Mr. Johnson.

Mr. CALVIN JOHNSON. I know a man who sold some stock to buy his daughter a horse, and that is what capital gain is about. Capital gain is given to people who pull their money out of investments and put it into consumption.

The real estate industry already has rollover privileges in 1031 like kind exchanges and the ability to release property from one use to another. If you sell, paying substantial tax, you are not selling to reinvest.

There is an economic theory called the efficient market thesis that said that you cannot make money selling investment A in order to buy investment B. You can't make money selling Yugos to buy Lexuses. You can't make money by selling junk investments to buy good investments.

Why? Because the smart market has already taken account of relative quality in the pricing. You will have to sell the junk for a cheap price and have to buy the good for a high price. Nobody sells to reinvest once they have to lose a big part of their capital.

The more tax you have involved in any sale transaction, the more money at stake, the more money we are really talking about, the more I can state with confidence that that person is selling in order to consume, not in order to reinvest.

The economists are also finding a mailbox effect that shows that people consume cash that you give them in hand.

Mr. PAYNE. Let me just say my experience in the industry I think runs more closely to the first four than the last respondent.

Thank you.

Mr. HERGER. Thank you very much.

Mr. McCrery will inquire.

Mr. MCCRERY. Before I inquire, does anybody else on the panel wish to respond to Mr. Johnson's comments?

Mr. KACHADURIAN. Mr. McCrery, I would just say that personally and on behalf of our firm, we have reinvested proceeds from selling one property virtually on the same block after selling one property on the same block and reinvesting it in another, and that is, to improve the second property, we have brought our management expertise, improved property A to a point where we thought that property is at its fullest potential, reinvested the proceeds in property B to improve that property, so in our case we have reinvested that equity.

Mr. MCCRERY. Do you have to pay tax on that capital?

Mr. KACHADURIAN. Well, in certain cases, we are all cash investors, in certain cases, it is debt, it just depends on a particular case in point, but if there is a gain, yes, we pay a tax.

Mr. MCCRERY. Thank you. Mr. Woods, I appreciate your bringing up the possible expansion of the American dream savings account to allow parents and grandparents to make withdrawals for first-time purchase of a home for their children or grandchildren.

I think that would be an excellent improvement of the proposal, and, as you say, would encourage home construction and home buying. Just on the chance, Mr. Johnson, let me ask you, do you have any thoughts on the current tax treatment of leasehold improvements? Do you think it is fair today as it is in the Tax Code?

Mr. CALVIN JOHNSON. There is no question that if the tax life is too long, it should be shortened. Our goal is to describe the taxpayer's true investment, and if there has been an anomaly under which his adjusted basis is below fair market value, then we ought to do something, although I think there is a lot of self-help, taxpayers sell and get that adjustment, but basis should equal real investment, and if the basis is too high, higher than your real savings account equivalent investment, then correction needs to be done.

Mr. MCCRERY. Good. Thank you.

Mr. Didion, you mentioned a couple of avenues to correct the current tax treatment of leasehold improvements. If you can't get the life of the lease as the term for depreciation, what would you think would be a fair term in the code if you had to just put in a static term for depreciation?

Mr. DIDION. We would put in a term of 10 years. The average lease term that tends to be written in across-the-board commercial leases is probably closer to 7 years, but that is a little too fast, I think, and a 10-year term when you look at all types of improvements seems to make sense to us.

Mr. MCCRERY. Anybody else have any idea on that or is that pretty much the thinking of the industry?

Mr. FREEMAN. Shopping centers, on an average, go through a major remodel about every 10 years, certain types of stores, restaurants, food stores, maybe it is as little as 5 years. Others are longer, but I think 10 years would be appropriate.

Mr. MCCRERY. OK.

Thank you, Mr. Chairman.

Mr. HERGER. Thank you, Mr. McCrery.

Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. I was interested, Mr. Woods, in your example of the number of folks whose incomes are $25,000 to $50,000 a year who would find some positive things to say about a decrease in the capital gains tax, and I am wondering, sometimes we are accused politically of having that change that we recommend in our Contract With America affect only the wealthy people.

How do we sell the fact, what examples do we use that it affects people all over this country?

Mr. WOODS. I think you are absolutely right. To be honest, I was surprised, too, when I saw that statistic because that is not a statistic that I knew about before, just a few days ago, and when I saw that 20 percent of all the families in this country own income property with an income between $25,000 and $50,000, I was really surprised because I wouldn't have guessed anywhere close to that.

When you go up a little bit more and you are talking about between $50,000 and $100,000, it is certainly still not people that anybody would categorize as rolling in money, you talk about 30 percent, so there is a 50-percent increase from that next click up of income, so it really, I guess it is the people that you don't think about, the people that own the two-family house, the people that own the three-family house, and those are the ones we think, investors sometimes think about shopping centers and apartment buildings, but we forget the husbands and wives with two kids and a dog that own a three-family house, and maybe they are going to live in it for their entire life, but they are investors, just like everybody else.

Ms. DUNN. Thank you.

Mr. Freeman, other real estate groups have spoken in favor of changes in the depreciation schedule for leasehold improvements. Has ICS taken a position on this?

Mr. FREEMAN. We would certainly like to see it shortened. Thirty-nine years is a very long time, and major improvements in our industry average at least every 10 years and various parts of it half that, so current schedules are exceptionally long, more than double or triple what we see as normal in the industry.

Ms. DUNN. Good. Thank you. Mr. Woods—Mr. Chairman, I am moving on to another topic just briefly, but I want to take advantage of Mr. Woods' background and the background of any of the rest of you in asking you about the flat tax proposal that Congressman Armey has proposed.

I have heard from people in my district, some of whom are realtors, some concern and others say that, no, the fact that mortgage interest deductions would not be allowed under the flat tax still won't influence the industry because people like to own their own homes and their own property.

Could you comment on whether this is a good thing or a bad thing for your industry.

Mr. WOODS. I could comment whether it is a good thing or a bad thing if you could tell me how we are going to work the parameters and exactly how we are going to do it.

You know, there are real questions about it, there are questions I am sure amongst everybody that speaks about a flat tax. It has to do with how are we going to control it and if we put together a flat tax and we pass a flat tax and we have support for it and then it is changed 2 or 5 or 10 years down the road to something entirely different, well, then, you would have to say, no, we would be probably violently opposed to it, but if there were some safeguards that could be put into it so we knew that we were going to have a flat tax and the flat tax was going to remain flat, well, then, I think you would have to look at that in a whole different light, and you would have to examine the impact that it would have.

Buying a piece of property and owning a piece of property, it is a multifaceted investment. I mean, you have interest rates and you have the benefits. One of the benefits that you have always had is the fact that there is mortgage interest deductibility, and to give something up that has been in our Tax Code ever since we have had a Tax Code like that, you would really have to make sure that the controls are in there, so it can't be a stocking horse for something else, and we give that up as an industry and as all the homeowners, the 65 percent of the population that owns homes, and then we find out 5 years from now we have given it up for nothing.

Ms. DUNN. Does anybody else wish to comment on that question? Thank you, Mr. Chairman.

Mr. HERGER. Thank you.

Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman. Certainly I would have to agree with you that we have to revisit the tax laws to make certain that we remain competitive and to generate more jobs and more revenues for the United States.

Now, the President and Chairman Greenspan would have me to believe that this economy is really pumping, that we have reduced the deficit, that factory capacity is topped out, that interest rates and inflation are down, that millions of jobs have been added, and that it is his concern that it has been the deficit reduction that has dramatically caused this healthy attitude. And of course, as he indicated in his State of the Union speech, that many Members that voted for that tax increase in order to reduce the deficit are not here. So, he feels very strongly about that. And, as you might suspect, many of the proposals that are being supported here, especially capital gains, there is a lot of concern by Treasury and other economists that the figures may look good the first 5 years, but they become really much worse in the next few years.

Knowing that you all agree that we have to have a balanced budget and that we can't load the deficit and that we would have to have cuts to do all of these things, how would you answer the President that it ain't broke, so don't fix it?

How about Mr. Freeman because I want all of America to love me and I want to do the right thing. I would rather have all America's love than the President's. So how would you say—he has really impressed himself and the Federal Reserve Board that America is now moving, and he doesn't want anything or anybody to stop that movement, and I think all of you have to agree that we are doing a heck of a lot better for whatever reasons in the last 2 years, right? Right, right, right, right. Not good at elections, but the economy is recovering, right? Probably it was something that Reagan thought about, but anyway——

Now what are we going to do, Mr. Freeman?

Mr. FREEMAN. Congressman Rangel, I am really going to sleep well tonight knowing that everything is in such good shape.

Mr. RANGEL. No, no, you have to tell the President through me about where he is wrong and you have got to tell this guy Greenspan how he is wrong. I mean, he is so excited about how well he is doing, he wanted us to sign $40 billion guarantees to foreigners, so you know he is excited about how strong we are, how strong the economy is.

Now, you know, I have witnesses to many of the things that you are proposing. Unfortunately, you know, the mandated balanced budget, that is all right, but I want answers, what would you say if the President is saying you are right, but give me a break, not now.

Mr. FREEMAN. I am going to give an answer, and believe me I am not trying to be a smart aleck, but the rest of America has to balance its budget every day, and Congress needs to do it, too. I don't know how else to answer it.

Mr. RANGEL. That is not a smart aleck. The President would say I am doing that, and you are asking me to do something that would cause me to do things that are more painful.

The economy is moving, and he is not complaining about balancing the budget, he is way ahead of you in terms of reducing the deficit, so that is not an issue.

The issue is he is saying that the economy doesn't need this jump start that you want to give it, and I am not arguing with you because you have been introduced by one of the most esteemed members of the committee, so I respect her judgment, and your connection with a higher authority, but tell me, what would I tell my President?

Mr. FREEMAN. It is time to do it, and we have to do it.

Mr. RANGEL. Anybody want to help him before the red light comes on?

Mr. KACHADURIAN. Mr. Rangel, I would again add that there are transactions that are not occurring with the present capital gains tax. Freeing up those transactions and freeing up that capital will produce more revenues for the Treasury and lower the cost of capital.

Mr. RANGEL. No one challenges—well, I am not going to challenge you for the first 5 years, but when you get out to the next 10 years, there seems to be a lot of storm out there about the dramatic shortfall.

Do you challenge that?

Mr. KACHADURIAN. Well, I am personally not that involved and knowledgeable about the discussions about after 5 years.

Mr. RANGEL. OK. Listen, I am all right.

Thank you, Mr. Chairman.

Mr. HERGER. Thank you, Mr. Rangel.

Mr. Christensen will inquire.

Mr. CHRISTENSEN. Well, I am batting 1,000, Mr. Chairman.

You know, I have heard testimony again today from a panel of individuals in the private sector, working, representing various interests, and then comes along an academician or a government bureaucrat who is against the capital gains tax reduction or neutral cost recovery or anything that is going to give more power back to the small businessowner and the American family.

I am going to give you the benefit of the doubt, Mr. Johnson. Let's say we didn't do a couple of the things in our proposal here. Let's just say we did the capital gains tax reduction, would you still be opposed to the bill?

Mr. CALVIN JOHNSON. I think capital gains reduction unlocks lots of capital for consumption. You have a very strong mailbox effect under which you give people big cash and they consume it. Real estate has lots of opportunities to roll over their investment if they wanted to keep money invested. That is not where the demand is coming from.

Mr. CHRISTENSEN. Mr. Johnson, capital gains does not apply only to real estate.

Mr. CALVIN JOHNSON. I am sorry, I don't understand.

Mr. CHRISTENSEN. There are a lot of things that we can do.

Mr. Didion, Mr. Freeman, would you like to respond? I wanted to follow up on Mr. Payne's questioning also. Are there other things that we could talk about as far as what Mr. Johnson is referring to?

Mr. DIDION. I guess I am in just fundamental disagreement with Mr. Johnson in his view that the sale of an asset in fact changes the character of the incentive to invest the money that derives from that sale. My sense is he is talking about apples and oranges, and I just don't fundamentally agree with him.

Mr. CHRISTENSEN. Mr. Freeman.

Mr. FREEMAN. I agree.

Mr. CHRISTENSEN. Mr. Kachadurian.

Mr. KACHADURIAN. I agree.

Mr. CHRISTENSEN. Mr. Woods.

Mr. WOODS. I agree also.

Mr. CHRISTENSEN. I just wanted to make sure there wasn't something I was missing.

Thank you.

Mr. HERGER. Thank you, Mr. Christensen.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I am going to be brief. I apologize to the panel for getting here late, but I was able to figure out which one is the professor, with all respect, Professor Johnson.

Representing the world's largest shopping center, the Mall of America, I am pleased to see you here today, Mr. Freeman. I think you are too humble. I think you present a very articulate defense of the reasons for capital gains tax reduction and the effect on the macroeconomy, so I am going to send your testimony to the White House to answer the question that was addressed to you today. I think you very effectively, as you put it, break the myth that the capital gains reduction is somehow a tax break for the rich as well.

But I want to ask you another question. In your testimony you mentioned the exclusion of net lease property from capital gains indexing. Could you elaborate on this? You didn't get much time. It was toward the end of your testimony.

Mr. FREEMAN. Thank you, Congressman. I would like to—that is the one—we are very happy with this bill, mind you, we are not trying to be critical, but there is one part of it.

In the past 20 years during the time this net lease provision somehow found its way into the capital gains law, our industry has changed from what used to be basically a gross lease to a net lease, and so—when I refer to us being caught as the dolphin in the net, when this provision was drafted, our industry didn't do it this way, and we, believe me, we are not passive investors, this is not something that we just do as a hobby.

For most of us, this is our work, and these leases are net, the rent is listed separately from the other expenses, and they are basically in that lease, so if we were not to make some technical correction here, it would preclude us from the advantages of capital gain that we so badly need.

Mr. RAMSTAD. Thank you for that clarification. I want to thank all of the witnesses. I also want to thank you as long as the green light is still on, Mr. Freeman, your organization in particular has been very helpful, particularly Jim Hale, my good friend from Minneapolis and Judy Black, in providing input. I really appreciate that. As a new member of the committee, it has been very helpful.

Thank you very much.

Mr. FREEMAN. Thank you.

Mr. HERGER. Thank you, Mr. Ramstad.

We do have a vote going on. We will recess for 15 minutes, and, at that time, we will call up our next panel. Thank you very much.

Mr. RANGEL. Could I ask the professor one question before we go?

Mr. HERGER. Yes.

Mr. RANGEL. Professor, I did not know by the title you had that you were teaching economics, and certainly I normally yield to those people that are out there doing it rather than those who study and teach it, but if the capital gains tax reduction actually passes, do you personally stand an opportunity to have any gain in terms of income?

Mr. JOHNSON. Yeah.

Mr. RANGEL. So you really are testifying against your own self-interest there?

Mr. JOHNSON. Yes. We are system loyal, that is what teachers do.

Mr. RANGEL. Thank you very much, Professor.

Mr. HERGER. Again, I thank our panelists for your testimony, very helpful. We do have a vote on now. We will recess for 15 minutes and return for our final panel.

Thank you.

[Recess.]

Mr. ENGLISH [presiding]. Thank you very much. Calling the meeting to order.

I am happy to reconvene this hearing of the House Ways and Means Committee and entertain comments from our final panel.

Serving on that panel are Michael Callahan, executive vice president and chief financial officer of the FMC Corp. on behalf of the Chicago Coalition for the Reform of AMT, welcome; Wayne E. Chambers, member, board of directors of the Association of Progressive Rental Organizations in Austin, Tex., welcome; Alan E. Ross, chairman of the board of directors of the Semiconductor Industry Association and president, telecommunications, Rockwell International Corp. of Newport Beach, Calif., welcome; and Thomas B. Rumfelt, owner and chief executive officer, Risk and Insurance Brokerage Corp., Lake Wales, Fla., welcome.

What I will do is give you an opportunity to each speak for 5 minutes. If you have any additional testimony, you can submit it for the record, and then we will have members of the panel submit questions to you. Thank you.

Mr. Callahan.

STATEMENT OF MICHAEL CALLAHAN, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, FMC CORP., ON BEHALF OF THE CHICAGO COALITION FOR THE REFORM OF AMT

Mr. CALLAHAN. Thank you, Congressman. Mr. Chairman and members of the committee, not many here at this late hour of the day, wish there were more, the Chicago Coalition for the Reform of AMT appreciates this opportunity to express its views to the committee on the important subject of capital cost recovery within the context of the Job Creation and Wage Enhancement Act.

My name is Mike Callahan, and I am executive vice president and chief financial officer of the FMC Corp., a diversified manufacturer with headquarters in Chicago.

However, I am speaking on behalf of the coalition, which you mentioned, which consists of eight Illinois-based companies with their headquarters in and around Chicago, such as the Amoco Oil Co., United Airlines, Chicago Bridge & Iron, and a number of others, although obviously their operations are spread throughout all of the United States.

We agree with the committee that the subjects of future investment by business, capital formation, and the rates of capital recovery for tax purposes are all very important to capital formation and the creation of jobs. As you know, the Tax Code has had a significant impact on the potential return on future investments made by businesses.

Our coalition is concerned that the existing alternative minimum tax system, as it is currently in effect today, has a negative effect on project investment returns. As a result, American capital investment behavior has been negatively affected, and in reality American business has become less competitive.

Now, earlier in the week you heard testimony by the American Council of Capital Formation and others that it would attest to these general macroeconomic aspects of the current system. We are really very pleased by your committee's proposals that they address these issues, and we would really like to make some very specific and simple comments in the time that you have given us today.

First, our coalition specifically supports your efforts to eliminate the economic distortions caused by the capital cost recovery provisions of the Tax Code for both regular and AMT taxpayers to encourage new investment in plant and equipment and the creation of new jobs through the enactment of the NCRS.

In addition, it must be realized that for AMT taxpayers, such as the members of this coalition, the intended benefits of the NCRS can only be fully realized if fundamental corrections are made to the AMT capital cost recovery system.

Even with the changes made in this area by the NCRS proposal, AMT taxpayers must wait on average twice as long for the recovery of their capital versus regular taxpayers. Thus eliminating the current law, AMT capital cost recovery system with this built-in disincentive to investment should be a priority for Congress and this committee to both increase investment and promote job creation.

Therefore, this coalition would propose that for taxpayers which elect NCRS, the AMT and the regular tax capital cost recovery system should be made the same to in effect level the playingfield for all taxpayers.

Second, if for any reason the NCRS initiative should not move forward, this coalition would urge this committee to look for a more narrow targeted solution to meet substantially the same objective. Specifically we would propose that the most beneficial change which can be made would be to reform the AMT system in the following ways:

One, the AMT depreciation system should be conformed to the existing system available to regular taxpayers for all future, not past investments. This part of the proposal is pretty straightforward for the same reasons mentioned above. Two, all long-term AMT taxpayers should be allowed to utilize their built-up AMT tax credits to reduce current and future year AMT tax, but not below the amount payable under the regular tax system. This proposal would provide relief across the entire spectrum of AMT taxpayers who may never receive the benefits of these credits, which was not really the intent of the law back in 1986.

Why do we make these recommendations at this time? Each member of the companies of our coalition is significantly affected by AMT. At the time of the enactment of that law, it was really assumed that the companies would be subject to the AMT for, say, 1 or 2 years when profits were low and use of credits or deductions happened to also be high. Thus the AMT would result in a temporary prepayment of tax with credits to be used in future years.

In practice, the AMT system has not worked as planned for many taxpayers, and that has been pretty well documented by a number of studies, since many taxpayers pay AMT every year and cannot claim AMT credits as contemplated. FMC, my company, is an example of just such a company, having been subject to AMT in each year since the AMT system became in effect.

If you look at the credits building today and going forward that we would not have for investment, this is money that really could have gone for investments and is really not going to go into the system simply because of the nonuse of the AMT credits. Therefore, this proposal would return the operation of the AMT to that of a temporary prepayment of tax and help mitigate this investment disincentive which the AMT currently imposes on all AMT taxpayers.

Mr. ENGLISH. Mr. Callahan, would you like to complete your remarks, then summarize, and I will go to Mr. Chambers.

Mr. CALLAHAN. Thank you, sir. In closing, the coalition again wants to applaud the direction of your committee. We are encouraged that we are seeing some meaningful change. I think consistent and stable change is what would create an environment to give us the confidence to invest on a sustainable basis, and we would like very much to work with you in your proposal as we go forward.

[The prepared statement follows:]

Committee on Ways and Means
1100 Longworth House Office Building
Testimony for the Written Record of Mr. Michael Callahan,
Executive Vice-President, FMC Corporation, speaking on behalf of
the Chicago Coalition for the Reform of AMT
Thursday, 26 January 1995

Mr. Chairman and other members of the committee, the Chicago Coalition for the Reform of AMT appreciates this opportunity to express its views to the committee on the important subject of capital cost recovery within the context of the Job Creation and Wage Enhancement Act. My name is Mike Callahan and I am Executive Vice-President and Chief Financial Officer of FMC Corporation, a diversified manufacturer with headquarters in Chicago. I am speaking on behalf of the Coalition which consists of eight Illinois based companies with their headquarters in and around Chicago.

As you know, the tax Code has a significant effect on both the potential return on future capital investments made by business, and the ability of business to make such investments. Following the enactment of the alternative minimum tax system, businesses that have been routinely subject to the AMT have been affected in a number of ways: capital intensive businesses had their capital recovery periods lengthened and the rates of recovery slowed; businesses with foreign operations which pay foreign taxes saw their ability to claim foreign tax credits subjected to a further limitation; businesses which export goods and help mitigate the still growing trade deficit saw their foreign sales corporation export incentives eliminated; and businesses lost their ability under the AMT system to use credits designed to encourage certain taxpayer behaviors, such as the creation of jobs and the investment in research and development.

By having a negative effect on the investment returns of projects and on business sales subject to the AMT rules, American business investment behavior also has been negatively affected; and as a result, American business has become less competitive. This is especially true for American manufacturing and service businesses that require significant investments in capital, and which also provide relatively high paying jobs to the American economy. Moreover, based on a study by the Treasury's Office of Tax Analysis, the AMT affects many more taxpayers than originally envisioned. In any given year, AMT will be paid by at least one out of every six companies with assets over $50 Million. AMT is a significant tax! Therefore, our coalition encourages this Committee to reverse these barriers to future business investment.

Our coalition specifically supports efforts to eliminate the economic distortions caused by the capital cost recovery provisions of the tax code, and to encourage new investment in plant and equipment and the creation of new jobs through enactment of the NCRS. The coalition shares some of the concerns about the NCRS system previously expressed by others: Is there a need to slow the rate of capital recovery from 200% to 150% declining balance? Is there a more direct method of achieving the economic equivalent of a current deduction for capital costs so that the complexities associated with the NCRS system might be avoided? Is there a risk that the system could become mandatory rather than elective, thereby imposing the 150% recovery rate on all new investments? Is there a risk that the system could be altered or repealed before the benefits are realized? But the coalition believes that on balance, the direction of the NCRS proposal is both appropriate and beneficial. In addition, it must be realized that for AMT taxpayers such as the members of this coalition, the intended benefits of the NCRS can only be fully realized if fundamental corrections are made to the AMT capital cost recovery system. For taxpayers permanently paying AMT, the AMT capital cost recovery system is one of the slowest in the industrialized world. Even with the changes made by the NCRS proposal, AMT taxpayers must wait for the relief over the longer AMT recovery periods rather than the shorter periods available to regular taxpayers. Thus, eliminating the current law

AMT capital cost recovery system which acts as a disincentive to investment should be a priority for Congress and this Committee to fully achieve the intended increase in investment and to promote job creation. This coalition would propose that the AMT and regular tax capital cost recovery systems be conformed for taxpayers which elect the NCRS system. When the same depreciation rules apply to all taxpayers the investment incentives contemplated by the NCRS are achieved for all taxpayers and administration is simplified.

If, for any reason the NCRS initiative should not move forward, whether for political or budgetary reasons, this coalition would urge this committee to look for a more narrow, targeted solution to meet the same objective. Our coalition would propose that the most beneficial change which can be made would be to reform the AMT system in the following ways. First, the AMT depreciation system should be conformed to the existing system available to regular taxpayers, for all future investments. This part of the proposal is relatively straightforward. **In addition**, all long-term AMT taxpayers should be allowed to utilize their built-up AMT credits to reduce current and future years' AMT tax, but not below the amount payable under the regular tax system. This proposal would provide relief across the entire spectrum of AMT taxpayers, as described earlier. Either a dual tracking system for use of the AMT credits against future AMT and regular tax, or a system similar to that currently used to track investment tax credit carryovers for use against AMT could be used to achieve the intended result.

Each member company of our coalition is significantly affected by AMT, which was enacted in 1986 to prevent otherwise profitable companies from escaping taxation altogether through the use of deductions, credits or exclusions. At the time of enactment, it was assumed that companies would be subject to the AMT for one or two years when profits were low and use of credits or deductions happened also to be high. It was assumed that the AMT paid in those years would be used to reduce the regular tax in subsequent more profitable years through the credit mechanism enacted as part of the AMT system. Thus, the AMT would result in a temporary prepayment of tax. In practice, the AMT system has not worked as planned for many taxpayers, since many taxpayers pay AMT every year and cannot claim the AMT as credits as contemplated. Therefore, this proposal would return the operation of the AMT to that of a temporary prepayment of tax and help mitigate the investment disincentive which the AMT currently imposes on all AMT taxpayers.

In closing, the Coalition again wants to applaud the direction which the Committee is taking. We are encouraged that meaningful change may at last be at hand. Our Coalition wants to encourage the Committee to adopt provisions which can be sustained for the foreseeable future. Constant change in areas that affect business investment should be minimized; capital cost recovery provisions should be both favorable and stable to promote the certainty of result for the future which promotes investment, and is critical for job creation and the American economy. Permanently reforming the AMT system would be a very significant step to achieving all of these objectives.

Our Coalition has developed draft statutory language to achieve the objectives I have outlined and would be pleased to share it with the Committee if this would be helpful.

Mr. ENGLISH. Thank you, Mr. Callahan.
Mr. Chambers.

STATEMENT OF WAYNE E. CHAMBERS, MEMBER, BOARD OF DIRECTORS, ASSOCIATION OF PROGRESSIVE RENTAL ORGANIZATIONS, AUSTIN, TEX.

Mr. CHAMBERS. Thank you, Mr. Chairman. Mr. Chairman and distinguished members of the committee, perhaps my difficulties are a little bit more simplified than what we have heard today. I am a small businessman operating a company called Dow Rentals out of Houston, Tex.

I represent a majority of dealers who like myself rent household durable goods to consumers on a short-term basis. My industry has a major problem with the way the current depreciation laws are being applied. If a reasonable solution is not reached to bring about equity in the application of the depreciation laws, it will have a crippling effect on my business and those of the rental purchase industry.

I am here today to talk about these depreciation laws and suggest a couple of simple solutions. In my stores we rent televisions, VCRs, appliances, furniture, and other items for the home, usually on a week at a time or a month at a time basis. Most customers rent for a while and simply return the property. This usually happens after 3 to 4 months. Customers return the merchandise because their needs change or their financial circumstances change. Also customers can terminate the agreement at any time and have no obligation to make additional payments, or customers can renew the agreement for a stated number of periods, at which time title to the property is transferred to the customer.

Meanwhile, as a dealer, I am responsible for bearing the expense of keeping the merchandise in good condition. Statistics show that only 25 to 30 percent of the rental agreements result in the customer obtaining title to the property. Additionally, the average revenue generated by the products for a rental company is approximately 21 to 24 months. An average of three to four customers will rent the merchandise before it exits the store's inventory.

Because of the use and the abuse of the property during its rental life, it becomes economically unrentable within a 21- to 24-month period.

A word about our industry. I represent an industry that has approximately 7,500 store locations nationwide. We employ in excess of 50,000 people, and we do approximately $4.5 billion annually in revenues. Interestingly enough, in our industry 80 percent of the companies are generally called mom and pops who are owner-operators with five stores or less.

I also am a member of the board of directors of the Association of Progressive Rental Organizations which represents a majority of these businesses. So you ask what is my problem. After 6 years of litigation, a recent tax court decision mandates a cost recovery of rental property over 5 years under MACRS, even though the revenue stream of rental merchandise rarely exceeds 2 years. This creates an enormous distortion of income and the related tax liabilities.

The industry itself has generally used an income forecasting method as a form of depreciation on this rental merchandise matching the revenues with the cost of doing business. In my way of thinking, Mr. Chairman, depreciation should match revenues and the expenses that are utilized to obtain those revenues, and 5-year MACRS, as an example, simply doesn't do that.

What it means is that it makes me, as a small businessman, pay taxes on income that has not yet been received. An example might be if a new item of rental property is rented on January 1 in year one, after three or four customers have rented the merchandise, it completes its rental life on June 30 of year two.

Income forecasting, for example, recognizes two-thirds of the income and two-thirds of depreciation in year one and one-third of each in year two. Five-year MACRS recovers 20 percent of the cost in year one and 80 percent of the cost in year two, overstating the tax liability in the first year and understating it in the second year.

Some of the dealers in my business simply do not have the capacity to pay the accelerated tax liability. I propose a simple solution in our case. We would need for Congress to enact legislation clarifying the Tax Codes by authorizing the application of the income forecast method of depreciation for the rental purchase transaction used in this industry or alternatively, enacting legislation authorizing the depreciation of rental purchase property over a 3-year recovery period under MACRS.

This would provide a better match for revenues and expenses. It would also make it consistent with the statutes that already exist in 38 States, recognizing the rental purchase agreement as a valid lease and confirm them as a true lease for tax purposes.

Mr. Chairman, thank you for this opportunity to express the views of this industry.

[The prepared statement follows:]

STATEMENT OF WAYNE E. CHAMBERS
of the
ASSOCIATION OF PROGRESSIVE RENTAL ORGANIZATIONS
before the
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

January 26, 1995

Mr. Chairman and distinguished Members of the Committee:

My name is Wayne Chambers. I own and operate a rental-purchase business. I am also a director of the Association of Progressive Rental Organizations ("A•PRO"), which is a nonprofit national trade association representing the rental-purchase industry. The rental-purchase industry is comprised of hundreds of businesses that rent household durable goods to consumers on a short term basis. A•PRO represents nearly 500 of the businesses in the industry, most of which are small companies.

I am pleased to present to this Committee A•PRO's and my views regarding the principles of neutral cost recovery set forth in H.R. 9, the "*Job Creation and Wage Enhancement Act*." In particular, I want to discuss a cost recovery problem currently faced by the rental-purchase industry that should be addressed in connection with the proposed legislation.

By indexing depreciation against inflation, the proposed legislation promises to reduce the economic costs of the deferral of depreciation deductions. The economic costs to the rental-purchase industry of the deferral of depreciation deductions may well eliminate jobs and could even put some companies out of business. Inflation, however, is only one factor contributing to such economic costs. For the rental-purchase industry, unjustified economic costs of much greater magnitude are created by an IRS interpretation of tax rules (upheld in one case by the Tax Court) that would mandate cost recovery of rented property over five years (or longer). Under the IRS interpretation, rental-purchase property would be depreciable over a five year class life, even though the income stream generated by that property rarely exceeds two years. This postponement of cost recovery deductions cannot be justified on any theory of matching income with related deductions.

Description of Rental-purchase Industry

The rental-purchase industry is a young industry comprised of more than 7,500 stores throughout the 50 states that currently employ approximately 50,000 persons and are estimated to generate more than $4.5 billion of revenue per year. The typical rental-purchase dealer is a small company or sole proprietorship that has very limited capacity to finance its inventory with borrowed funds. Most of them have virtually no capacity to finance the additional tax liability attributable to the postponement of cost recovery deductions.

Rental-purchase businesses rent household durable goods -- such as furniture, TVs, stereos, VCRs, refrigerators, washers and dryers -- to consumers on a short term basis. Virtually all of the industry's customers are individuals who obtain the property for personal household use. While customers enter rental-purchase transactions for a broad variety of reasons, many customers enter the transactions becaue (i) they have only a temporary need for the property, (ii) they want no continuing payment obligations, or (iii) for a variety of reasons, they are not sufficiently creditworthy to purchase the item on a credit sale basis. Thus, the rental-purchase industry occupies an important niche among suppliers of household goods.

Rental-purchase transactions are designed to provide flexibility to customers by permitting them to obtain immediate use of the property on a week-to-week or month-to-month basis without incurring financial obligations beyond the one-week or one-month term of the agreement. Because the customer has no obligation to continue making rental payments, rental-purchase dealers do not conduct credit checks or require a deposit. The customer makes one rental payment on the date he enters a rental-purchase agreement and has no obligation to make any additional payments. The typical rental-purchase agreement has an initial term of one week or one month. Although a customer has the option to renew the agreement for an additional term of one week or one month, the customer has no obligation to renew the agreement. The customer can elect at any time to return the property (or have the dealer pick up the property) without any further obligation.

If the customer elects to renew a rental agreement for an item of property for the maximum number of rental periods stated in the agreement, title to the property is transferred to the customer. The maximum number of renewal periods stated in the agreement usually covers a period of 12 to 24 months, depending on the type, age and condition of the property. The customer also can purchase the property before the end of the maximum number of rental periods by paying an amount stated in the agreement. The purchase option price generally equals a stated percentage (usually ranging from 50% to 80%) of the payments that would be made during the remainder of all possible renewal periods stated in the agreement.

Industry experience shows that only 25 to 30 percent of all rental-purchase agreements result in the customer ultimately obtaining title to the property. On average, a customer will make rental payments and maintain possession of an item of rental property for approximately 12 to 14 weeks after which the customer returns the property to the dealer. An item of property typically is rented to three or four different customers before a customer obtains title or the dealer abandons the property. Moreover, rental-purchase dealers often experience theft of 10 percent or more of their inventory per year.

Rental Income Stream

The average stream of income from an item of rental property is approximately 21 to 24 months. After an item of property has been rented to two or three different customers and subsequently returned to the store, obsolescence and wear and tear force the rental-purchase dealer to reduce the rental amount and/or the maximum possible number of renewal periods. As a result, the third or fourth customer is more likely to renew the rental-purchase agreement enough times to acquire ownership of the used property. Moreover, because renters tend to treat property with less care than owners, the used property often becomes unrentable and must be abandoned by the rental-purchase dealer. Thus, because of customer payouts and the destruction or theft of rental-purchase property, on the average a dealer's income stream from an item of property does not exceed two years.

Cost Recovery

Income Forecast. Members of the industry generally have depreciated rental-purchase property using the income forecast method.[1] Under this method, a rental-purchase dealer's depreciation deductions are closely matched with the income stream generated by the rental property. Using the income forecast method, the annual depreciation deduction is determined by multiplying (i) the adjusted basis of an item of property by (ii) a fraction, the numerator of which equals the amount of rent received during the year under all agreements relating to such property, and the denominator of which equals the total estimated rent that will be received over the remaining life of the property. For example, if rent in the amount of $50 is received during the year from an item of property, and the item of property had been expected to generate a total of $150 over its remaining life, then the depreciation deduction for the year using the income forecast method equals one-third (50/150) of the adjusted basis of the property.

Five-Year MACRS. Late last year, the U.S. Tax Court held that a particular rental-purchase dealer could not use the income forecast method. ABC Rentals of San Antonio Inc. v. Commissioner, T.C. Memo 1994-601 (December 7, 1994). Despite its finding that the rental property on average remained in the taxpayer's inventory only 21.6 months, the Tax Court indicated that the rental-purchase dealer was required to depreciate its rental property under Section 168 of the Code using a MACRS class life of five years.[2] The Tax

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[1] Section 168(f)(1) of the Internal Revenue Code allows a taxpayer to elect out of the Modified Accelerated Cost Recovery System ("MACRS") depreciation rules and properly use a method not expressed in terms of years. The income forecast method is such a method.

[2] For purposes of computing the alternative minimum tax, such rent-to-own property generally would be depreciable using a MACRS class life of nine years.

Court held that the income-forecast method could be used only for property that is "similar in character" to motion picture and television films and sound recordings.

Economic Harm from Deferral of Depreciation

If rental-purchase property is required to be depreciated using a five-year class life there will be a significant mismatch between the income stream generated by an item of rental property and the costs of producing that income. Such a mismatch will result in income from that property being taxed more quickly than it should be, to the economic disadvantage of the dealer. While the income stream from an item of rental property in general is spread over a 21 to 24 month period, the use of a five-year recovery period under MACRS defers most of a dealer's cost recovery until the last year the dealer uses the item of property in its rental inventory. The postponement of the rental-purchase dealer's cost recovery deduction is a significant economic loss based on the time value of money. The loss reduces the dollar amount available to a rental-purchase dealer to reinvest in new rental inventory items. The economic harm is particularly acute because most rental-purchase dealers are small companies or sole proprietorships that have very limited capacity to finance their inventory with borrowed funds. Thus, the postponement of cost recovery deductions will effectively reduce the volume of their business.

As an illustration, assume that a dealer acquires an item of rental property and places it in service on January 1 of Year One and depreciates the property using five-year MACRS (using the applicable half-year convention and the double declining balance method). Assume that a customer ultimately obtains title to the property as of June 30 of Year Two. In this example, 66⅔% of the dealer's rental income from the property is recognized in Year One, and 33⅓% of the rental income is recognized in Year Two. Using five-year MACRS, the dealer recovers only 20% of the costs of the property in Year One as a depreciation deduction, and recovers 80% of the costs in Year Two.[3]

	Percentage of Income	Percentage of Cost Recovered Using Income Forecast	Percentage of Cost Recovered Under 5-Year MACRS
Year One	66 2/3%	66 2/3%	20%
Year Two	33 1/3%	33 1/3%	80%

[3] To the extent the dealer places property in service later in Year One, the mismatch is less dramatic, but nonetheless significant.

This mismatch between the timing of a dealer's income and cost recovery deductions causes an economic distortion. The dealer's taxable income and tax liability during the first year of the life of an item of rental property are unfairly overstated. Although the dealer's taxable income and tax liability during subsequent years is understated, the dealer bears the economic burdèn of the time value of the front-loaded tax liability.

Recommendation

A•PRO urges Congress to enact legislation expressly authorizing the application of the income forecast method for depreciating rental-purchase property. The tax law should reflect the actual business conditions in, and practices of, the industry. To require the MACRS depreciation period of five years results in a mismatching of revenue and costs in the rental-purchase industry. By reflecting depreciation for the periods that the property is actually leased, the income forecast method properly matches costs and revenue and more clearly reflects income.

Alternative Recommendation

In the alternative, A•PRO urges Congress to enact legislation authorizing the depreciation of rental-purchase property over a three-year class life under MACRS. Although three-year MACRS would not match a rental dealer's income with its depreciation costs as closely as the income forecast method, a three-year class life would provide a closer match (and a clearer reflection of income) than a five-year class life under MACRS.

* * *

Legislation expressly providing for depreciation of rental-purchase property under the income forecast method (or over a three-year class life) would reduce the economic costs to the rental-purchase industry of the unjustified deferral of cost recovery deductions until the end of a rental dealer's income stream. Moreover, consistent with statues in 38 states recognizing rental-purchase agreements as valid leases, such legislation would expressly confirm that rental-purchase agreements are true leases for tax purposes. Without such legislation, the economic costs to the rental-purchase industry of the unjustified postponement of cost recovery deductions will unnecessarily paralyze these small businesses, causing some to close.

Thank you for the opportunity to present my statement on this important issue.

Mr. McCRERY [presiding]. Thank you, Mr. Chambers.
Mr. Ross.

STATEMENT OF ALAN E. ROSS, CHAIRMAN, BOARD OF DIRECTORS, SEMICONDUCTOR INDUSTRY ASSOCIATION; AND PRESIDENT, TELECOMMUNICATIONS, ROCKWELL INTERNATIONAL CORP.; ACCOMPANIED BY JOHN J. SALMON, COUNSEL

Mr. ROSS. My name is Alan Ross, I am chairman of the board of directors of the Semiconductor Industry Association and president of the telecommunications group of Rockwell International Corp.

I am accompanied today by John Salmon of the law firm of Dewey Ballantine, who is the SIA counsel. I am here on behalf of the Semiconductor Industry Association to discuss the proposed neutral cost recovery system's impact on semiconductor manufacturing equipment and the need for economically accurate cost recovery rules.

Semiconductors are the crude oil of the information age, driving technological advances in computers, telecommunications, and consumer electronics, and changing our society in ways ranging from telecommuting to electronic banking to promoting citizen access to legislation through the Internet.

Semiconductors are at the heart of the $500 billion U.S. electronics industry that employs 2.3 million Americans. The U.S. semiconductor industry alone provides over 200,000 American jobs and has recently regained its position as the world's leading producer of silicon chips.

It is a highly dynamic industry based on an ever evolving technology that demands continuing changes to our manufacturing infrastructure. This rapid pace of technological change results in equipment that becomes obsolete technologically and economically soon after being placed into service, but U.S. tax rules depreciate semiconductor manufacturing equipment over 5 years, a period significantly longer than the equipment's true economic life.

As a result, the U.S. semiconductor industry is at a competitive disadvantage with foreign firms whose cost recovery rules far more accurately reflect realities of the marketplace. The Job Creation and Wage Enhancement Act aims to stimulate economic growth and capital investment by reflecting the true cost of investment in depreciable assets. Indexing depreciation deductions will significantly affect investment in longer term assets.

However, the proposed system will provide little positive cash flow impact for short-lived assets. These assets will be subject to a reduction in the current law declining balance method but will not benefit significantly from indexing.

The problem is compounded for semiconductor manufacturing equipment because its statutory class life set by Congress in 1986 now is clearly longer than its economic life. To encourage capital investment in semiconductors, the SIA urges Congress and the administration to reduce the depreciable life of semiconductor manufacturing equipment from 5 years to 3 years.

The case for an adjustment in the depreciable life of semiconductor manufacturing equipment is clear, and we think compelling.

First, the technological life of semiconductor manufacturing equipment is shorter than the current law's 5 year classification. Two recent reputable economic studies have demonstrated that two-thirds of the economic life of semiconductor manufacturing equipment is exhausted in the first 24 months of use, and the full economic life of such equipment is less than 4 years, thus qualifying it for a 3 year class life under tax depreciation rules.

Second, more accurate cost recovery is necessary to offset the tax advantages enjoyed by foreign competitors. For example, Japanese firms enjoy a wide range of tax incentives for investment in semiconductor manufacturing equipment. As a result of these incentives, Japanese companies can write off up to 88 percent of their investment in new equipment in the first year, whereas U.S. companies can write off only 20 percent.

This neutral cost recovery proposal not only fails to address this unfair advantage, it would actually reduce first-year depreciation of semiconductor equipment to 15 percent. As such, several of our members have already indicated that they would not even elect to use the new system if it is enacted.

Third, faster depreciation is needed to continue to strengthen the global position of U.S. semiconductor equipment manufacturers. In 1980 all 10 of the leading semiconductor equipment manufacturers were U.S. companies. By 1989 four of the top five producers were Japanese.

However, U.S. firms have managed to regain their position in the highly competitive environment by undertaking a strong commitment to new capital investment. In 1992 the National Advisory Committee on Semiconductors, a government industry panel established by Congress to develop a national semiconductor strategy found that setting semiconductor manufacturing equipment's depreciable life at 3 years would have the most significant impact on the industry, increasing semiconductor industry capital investment by 11 percent per year.

In recent years Members of Congress of both parties, including Speaker Gingrich, Majority Leader Armey, Democratic Leader Gephardt, and many members of this committee have cosponsored bills to align the depreciable life of semiconductor equipment with economic reality.

We urge the Congress to act now to ensure that the industry is able to meet its future capital needs and maintain its leadership in promoting U.S. economic growth.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF ALAN E. ROSS
SEMICONDUCTOR INDUSTRY ASSOCIATION

My name is Alan Ross. I am Chairman of the Board of Directors of the Semiconductor Industry Association (SIA) and President, Telecommunications, of Rockwell International Corporation. I am accompanied by John J. Salmon of the law firm of Dewey Ballantine, SIA's counsel. The Semiconductor Industry Association is pleased to have this opportunity to testify before the Committee on Ways and Means about the need for more economically accurate cost recovery rules. In particular, I am here to discuss the proposed neutral cost recovery system's impact on short-lived assets such as semiconductor manufacturing equipment.

SIA is an association of U.S.-based semiconductor manufacturers that account for ninety percent of all U.S. semiconductor production. SIA was formed in 1977 to address public policy issues impacting the industry's ability to remain internationally competitive. Semiconductors are the enabling technology for the $ 500 billion U.S. electronics industry that employs over 2.3 million Americans. The U.S. semiconductor industry alone provides over 200,000 American jobs and is once again the world's leader in this most critical of technologies. We have regained our position in a highly competitive environment through strong commitments to research and new capital investment. The semiconductor industry is a dynamic industry using ever evolving technology that demands large changes to manufacturing infrastructure on an ongoing basis. It is anticipated that, globally, the semiconductor industry will invest more than $ 120 billion during the remainder of this decade to develop new fabrication facilities needed to keep pace with the rapidly changing nature of semiconductor technology.

This rapid pace of technological change results in equipment that becomes obsolete, technologically and economically, soon after being placed into service. Nevertheless, U.S. tax rules depreciate semiconductor manufacturing equipment over five years, a period that two recent studies and normal business practice demonstrate is significantly longer than the equipment's true economic life. This inability to depreciate such property over a period that reflects its actual useful life places the U.S. semiconductor industry at a competitive disadvantage versus foreign competitors who receive substantially more advantageous depreciation. In recent years, Members of Congress of both parties, including Speaker Gingrich, Majority Leader Armey, Democratic Leader Gephardt, and many members of this Committee, recognizing the need to correct semiconductor manufacturing equipment's depreciable life rules, sponsored bills aligning depreciable life with economic reality.

The Job Creation and Wage Enhancement Act ("the Act") aims to stimulate economic growth and capital investment and to accurately assess the true costs of investment in depreciable assets. Increasing depreciation deductions to account for inflation and, for certain assets, for the time value of money, will significantly impact investment in longer-term assets, particularly those with class lives accurately reflecting their economic usefulness. However, the proposed system will have relatively little impact on short-life assets because these assets will be subject to a reduction in the declining balance method yet, will not benefit significantly from indexing. The problem is exacerbated for semiconductor manufacturing equipment because its class life is longer than economic reality. The proposed neutral cost recovery system, therefore, would not sufficiently improve the U.S. semiconductor industry's competitive position in relation to its primary foreign competitor, Japan, or adequately stimulate the industry's level of capital investment. SIA urges Congress and the Administration to encourage capital investment in semiconductors by changing the depreciable life of semiconductor manufacturing equipment from five to three years. This change will correct the existing system's failure to allow semiconductor manufacturing companies to recover the real cost of their capital investments.

BACKGROUND

A vibrant, world-class semiconductor industry is universally acknowledged as vital to America's national security and economic growth. Semiconductors are the "crude oil" of the information age -- driving technological advances in computers, telecommunications, and consumer electronics. Semiconductor technology is the heart of a growing $ 1 trillion world electronics industry that employs 2.3 million Americans. In 1994, the global semiconductor industry had sales of $ 100 billion. Semiconductors are essential for defense capabilities, playing an important role in 18 of the 21 defense-critical technologies identified by the Department of Defense.1/

The semiconductor industry's pace of technological change is astounding. The number of transistors on a computer chip increased from 10 in the early 1960's to 10 million today. By the year 2,000, the U.S. industry hopes to place over 10 billion transistors on a single chip. This chip could store the equivalent of a 20-volume encyclopedia, or provide all of the computing power of one of today's leading-edge supercomputers.

This technology was invented in the United States. However, the U.S. industry's position as world leader steadily eroded during the 1980's. From 1982 to 1990, the U.S. industry's world market share declined from 56.7 percent to 39.8 percent, while Japan's share rose from 32.5 percent to 47.1 percent. Although, in 1993, the United States passed the Japanese in world market share, this position is tenuous with new investment needed to maintain and improve this mark. The earlier decline in market share occurred for a number of reasons:

- The U.S. industry has been injured by competing nation's unfair trading practices, including illegal "dumping" of their products in the U.S. market and denial of foreign market access. For example, Japanese dumping of DRAMs in the mid-1980's forced six of the eight U.S. DRAM manufacturers out of the market.

- Other governments made their semiconductor industries a national priority, "targeting" the industry by funding R&D consortia, extending low-interest loans, and providing favorable tax depreciation treatment and other tax incentives. Our primary competitor, Japan, for example, allows first year depreciation of up to 88 percent of semiconductor equipment's original acquisition cost to be written off in the first year compared to only 20 percent allowed for U.S. firms.2/

- The U.S. lost many industries which use semiconductors, such as the consumer electronics industry.

- Between 1984 and 1989, Japanese firms invested $ 12 billion more in plant and equipment and R&D than U.S. firms.

U.S. and Japanese capital spending rates are particularly important, since there is a high correlation between investment and market share. The difference in depreciation rates between

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1/ See Department of Defense, *Critical Technologies Plan*, (Washington, D.C.: May 1991); and National Critical Technologies Panel, *Report of the National Critical Technologies Panel*, (Washington, D.C.: March 1991).

2/ Technecon Analytical Research, Inc., *Analysis of the Relative Economic Benefits of Tax Depreciation Policies for Semiconductor Equipment and Facilities in the United States and Japan*, 1991.

the United States and Japan negatively impacts U.S. capital spending and consequently lowers U.S. market share and competitiveness.

In 1992, The National Advisory Committee on Semiconductors (NACS), a government-industry panel established by Congress to develop a national semiconductor strategy, found that shortening semiconductor manufacturing equipment's depreciable life to three years would have the most significant impact on the industry's capital expenditure level by increasing semiconductor industry capital investment by 11 percent.

SIA strongly supports NACS's conclusions and recommendations. While the Act's other changes in tax policy would enhance U.S. capital formation, the NACS study and SIA's analysis of the current proposals indicate that a reduction in semiconductor manufacturing equipment's depreciable life would have a greater impact on increasing semiconductor industry capital investment.

THE SEMICONDUCTOR INDUSTRY NEEDS A DEPRECIATION PERIOD THAT ACCURATELY REFLECTS THE ECONOMIC LIFE OF ITS MANUFACTURING EQUIPMENT

The case for an adjustment in the depreciable life of semiconductor manufacturing is clear and compelling.

1. **The technological life of semiconductor manufacturing equipment is shorter than the current law's five year classification.** The semiconductor industry's rapid pace of technological change results in equipment that becomes obsolete, technologically and economically, soon after it is placed into service. In fact, in the first year of use alone, a substantial amount of the true economic life of this equipment is consumed. Two recent economic studies by American Appraisal Associates, and Lane, Westly Inc. show that the economic life of semiconductor manufacturing equipment is 3.75 and 3.27 years respectively. Because the current law's tax depreciation rules classify property with an economic life of less than four years as "three year property," semiconductor manufacturing equipment should be classified as three year property.3/

Historical trends indicate that every three years a new generation of semiconductors is released. These chips, on average, increase four times in performance and capacity over the previous generation. The introduction every three years of new generations of semiconductors results in rapid obsolescence because more advanced manufacturing equipment is required for volume production of state-of-the-art integrated circuits. This fact clearly indicates that a change in depreciation is necessary if the United States intends to maintain a world-class semiconductor industry.

2. **Faster depreciation is necessary to offset the tax advantages enjoyed by foreign competition.** Japanese firms enjoy a wide range of tax incentives for investment in semiconductor manufacturing and equipment. Japan provides for substantially more generous depreciation of semiconductor manufacturing equipment, allowing firms to accelerate depreciation if equipment is operated more than eight hours per day -- a significant advantage

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3/ American Appraisal Associates, *Depreciation Rates Report for Semiconductor Manufacturing Equipment*, January, 1992. Lane, Westly Inc., *Estimating The Proper Depreciation Lifetime for Semiconductor Manufacturing Equipment*, January, 1995. Under current law, assets with useful lives less than four years are treated as "three year property" and depreciated accordingly. This result will not change under the neutral cost recovery proposal.

given that most wafer fabrication facilities operate twenty-four hours per day. Additional accelerated depreciation is provided to companies that locate in certain geographical areas. As a result of these incentives, Japanese companies can write off up to 88 percent of their investment in new equipment in the first year, whereas U.S. companies can write off only 20 percent. The neutral cost recovery proposal fails to address this unfair advantage held by foreign competitors. Ironically, under the neutral cost recovery proposal, first year depreciation of semiconductor equipment will actually be reduced by 25 percent, so that only 15 percent of the asset can be written off in the first year.

3. **Faster depreciation is needed to continue to strengthen the global position of U.S. semiconductor equipment manufacturers.** The U.S. semiconductor equipment industry's market share eroded rapidly in the 1980's. In 1980, all ten of the leading semiconductor equipment manufacturers were U.S. companies. By 1989, four of the top five producers were Japanese. U.S. firms have regained their position in a highly competitive environment by undertaking a strong commitment to new capital investment. Continued investment on a large scale basis, however, is needed if the domestic industry is to maintain its position. Faster depreciation would increase U.S. capital spending, which would stimulate demand for semiconductor manufacturing equipment and strengthen the U.S. semiconductor manufacturing industry.

4. **Allowing firms to accurately recover capital investment costs is critical in industries characterized by rising capital costs and product prices that fall rapidly after introduction.** In 1992, the U.S. semiconductor industry devoted 14 percent of sales per year to capital spending and another 12 percent of sales to R&D. The cost of a new fabrication facility is currently more than $ 1 billion, and is rapidly approaching $ 2 billion. While prices for manufacturing facilities continue to rise, prices for semiconductor products drop sharply soon after they are introduced. From 1978 to 1989, the price per bit for DRAMs decreased at a compound annual rate of 26 percent.4/ This means that the window in which firms can hope to recover their investments is extremely small.

5. **The information highway is paved with semiconductors.** Semiconductors are at the core of all aspects of the information highway -- the computers, televisions, and phones as well as the satellites and switching systems connecting them. Supporting these pervasive electronics products is expected to help double worldwide semiconductor industry sales between now and the end of the century -- from $ 100 billion in 1994 to $ 200 billion in the year 2,000. To support a doubling of sales will require a doubling of plant and equipment. To double the worldwide industry's net fixed assets will require cumulative investments of about $ 120 billion in the remainder of this decade. U.S. tax depreciation rules will be one factor determining whether firms will build new plants in the U.S. or overseas.

Each billion dollar semiconductor fabrication facility requires 1,900 people to construct the building and about 2,000 people to make the manufacturing equipment in the building. Once operating, the facility supports 750 to 1,000 manufacturing jobs. The 214,000 U.S. semiconductor jobs and 38,500 semiconductor manufacturing equipment jobs are the base supporting the 2.3 million Americans employed by the U.S. electronics industry -- more than the U.S. automotive, steel and aerospace industries combined. U.S. tax depreciation rules that reflect the short economic life of semiconductor manufacturing equipment will help

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4/ From 1978 to 1989, the price per bit for DRAMs decreased by a factor of 37.8 -- from 48.39 millicents per bit to 1.28 millicents per bit.

insure that the 214,000 U.S. semiconductor employees have the tools they need to do their part in building the information highway.

6. **The Job Creation and Wage Enhancement Act does not address the needs of high-technology industries.** The neutral cost recovery proposal correctly attempts to remove inaccuracies in the existing system which limit companies' ability to recover the true cost of their capital investments. The proposal's indexing for inflation and a standard discount rate allow companies to recover the cost of inflation and the time value of money.

In spite of its intention to stimulate economic growth the proposal will not sufficiently improve the U.S. semiconductor industry's general competitive position or capital investment level. Although the proposal provides incentives for investing in assets with long lives, relatively short-lived assets, such as semiconductor manufacturing equipment, receive little economic benefit as the advantage of indexing over only a few years is offset by the loss of the 200 percent declining balance methodology. Industry analysis demonstrates that firms with long-lived assets will receive a substantially greater increase in their ability to recover cost than firms with short-lived assets. Under NCRS, the present value of the benefit of depreciation deductions for an investment in a twenty-year asset (discounted at 7 percent) will increase 24.3 percent, while increasing 6 percent for a similar investment in a three-year asset. Under the proposal, semiconductor manufacturers will remain unable to recover the real cost of their capital investment. The proposal therefore fails to achieve its goals of stimulating capital investment and economic growth in the semiconductor industry.

CONCLUSION

The United States must adopt capital formation policies which reflect the economic realities of the semiconductor industry and international competition. Adjusting the depreciable life from five to three years will more accurately reflect the rapid pace of technological change in the semiconductor industry. The resulting increase in capital investment will bolster the semiconductor industry and the semiconductor manufacturing equipment industry, thereby strengthening U.S. electronics firms. Such a change will reduce the gap between U.S. and Japanese capital spending in semiconductors, which is attributable to the wide range of incentives that the Japanese government extends to their industry. If the United States fails to correct the existing inaccuracy in capital investment cost recovery, the U.S. semiconductor industry will have great difficulty in making the large capital expenditures needed to stay at the forefront of technological innovation.

Microelectronics technology has had an enormous and pervasive impact on our quality of life and on the productivity of new and existing industries. There is every reason to believe that the pace of technological change will continue to accelerate. If America is not to be left behind, we must act now to ensure that the U.S. semiconductor industry is able to meet its future, large-scale capital investment needs. Congress and the Administration have expressed a true commitment to promoting U.S. high-technology industries. It is now time for Congress to act on that commitment by correcting the inaccuracies in the existing cost recovery system.

Mr. McCRERY. Thank you, Mr. Ross.
Mr. Rumfelt.

STATEMENT OF THOMAS B. RUMFELT, FOUNDER, OWNER AND CHIEF EXECUTIVE OFFICER, RISK & INSURANCE BROKERAGE CORP., LAKE WALES, FLA.; AND NATIONAL CHAIRMAN, NATIONAL BUSINESS OWNERS ASSOCIATION

Mr. RUMFELT. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, my name is Thomas B. Rumfelt, and I am founder, owner and CEO of Risk & Insurance Brokerage Corp., a small business headquartered in Lake Wales, Fla. R&IB is a full-lines property and casualty insurance agency. I am appearing at the request of the National Business Owners Association and currently serve as its national chairman.

Thank you, Mr. Chairman, for holding this hearing to find new ways to help America's small businessmen and -women, nearly 22 million strong, that are the driving force of our economy today. Although they represent slightly more than 10 percent of our population, it is small businessowners who are creating businesses, providing new jobs, and keeping local communities and big cities prosperous. They are our best hope for a future—a future of growth and opportunity for everyone.

What is it about small businessowners that sets them apart, that makes them so successful?

The fact that truly distinguishes them is their firm belief in the future. It is their optimism about the future and the opportunities it holds that prompts them to invest. They know that investment today will bring rewards tomorrow.

Too often, small businesses experience difficulties in getting ahead. Banks are often reluctant or unwilling to loan money. And government does not always extend a helping hand. Its policies are one of the greatest obstacles small businessowners face. In fact, tax policies are a disincentive for savings and investment—the sources of capital entrepreneurs need to start and expand companies. For example, the current tax treatment of capital gains hurts investments as well as small businessowners who spur growth and the many millions who benefit from it.

That is why it is important that this committee do something about the tax policies that inhibit growth. These policies punish both those who are willing to save and invest and those who help create businesses and the jobs and growth that our Nation needs. As any successful small businessowner will tell you, it is investment that drives business growth and productivity.

In 1989, I started my own company, R&IB. When we opened our doors, we had two employees—I was one—and we rented a small executive suite. I made a commitment to invest my personal savings from the beginning. I searched for the best talent, and I invested in training and technology to help our employees be their best. I invested in anything that would give our team an advantage, and it paid off. Five years later, I am pleased to say that my company has grown to 110 employees in our own commercial space. We now have several offices and our growth continues.

One secret of this success is a commitment to continued investment. Our future growth will continue to come from investment. Without it, I cannot envision our company remaining as successful and as profitable as it has been the years since its creation.

I know small businessowners can do more with a dollar than most other businesses because they have to. It is time that Congress remove the obstacles to investment in small business that pays for itself many times over. The cost recovery provisions are a good start to help small businessowners recoup more of the dollars they invest in plant, equipment, and technology. As a small businessowner, I endorse this proposal.

I can see how this provision will help promote business investment, improve productivity, which will also mean higher wages for employees. It is wrong to suggest that investment helps only the individual who makes it. Whenever my company invests in computers, in a building, or any other asset, many benefit from that investment.

I am pleased to see a proposed increase in spending of $7,500 that will bring the writeoff total to $25,000. This is an important change and one that will encourage investment. All of these proposals, if enacted, will result in jobs for Americans and products for the world. Incentives that encourage savings and investment are the very ones that promote economic growth.

I appreciate this opportunity to offer my views on the important tax and investment incentives contained in the Job Creation and Wage Enhancement Act.

Thank you.

[The prepared statement follows:]

TESTIMONY OF THOMAS B. RUMFELT
NATIONAL BUSINESS OWNERS ASSOCIATION, INC.

Mr. Chairman, Mr. Gibbons, and Members of the Committee, my name is Thomas B. Rumfelt, and I am the founder, owner, and chief executive officer of Risk and Insurance Brokerage Corporation, a small business headquartered in Lake Wales, Florida. R&IB is a full-lines property and casualty insurance agency with operations in several states. I am accompanied by Mr. J. Drew Hiatt, Executive Vice President and Director of Government Affairs of the National Business Owners Association.

I appreciate very much the opportunity to appear before this Committee to offer a small business owner's perspective on specific tax and investment provisions contained in the Job Creation and Wage Enhancement Act.

Thank you, Mr. Chairman, for holding this hearing to find new ways to help America's small business men and women -- nearly 22 million strong -- who are the driving force in our nation's economy today. Although they represent slightly more than 10 percent of our population, it is entrepreneurs who are creating the businesses, providing the new jobs, and keeping local communities and big cities alive and prosperous. They are our best hope for a better future -- a future full of growth and opportunity for everyone.

If one thing is certain, it is that small business -- and small business owners -- have to be one of the most-studied subjects in all history. It seems that everyone wants to know the secret of their success. Many have pointed to their ability to endure and wait out hard times. Some have focused on their capacity for developing ideas and bringing new products to the marketplace. Others have sought to explain their success by noting their remarkable determination and tenacity. Still others have said that the secret to their success lies in their hard work, in their self-confidence, and in their strong faith. I think there is a little bit of truth in all these explanations. But many Americans share the traits and talents that make small business owners successful. Having good ideas is not unique to small business owners alone and neither is the ability to work hard. Other Americans have good ideas and work hard as well.

What is it about small business owners that sets them apart, that makes them more successful in many cases than other business owners? The detractors of small business and those who deride their contributions and achievements over the years would say the success of small business is more luck than hard work, more luck than talent -- more luck than anything else. But I believe it is all the things I have mentioned. The one single factor that comes to my mind that truly distinguishes small business owners and makes them successful is their firm belief in the future. It is their buoyant optimism.

It is this optimism about the future and the opportunities it holds that prompts small business owners to invest for the future. This is why they invest in new ideas and businesses. They know that investment today will bring rewards tomorrow. And they are not the only ones who benefit from investment -- those around them benefit as well and often in equal measure.

Small business owners understand the value of investment and its potential and power to create business, jobs, higher wages, and economic growth. For them, it is easy to see how an idea fueled by investment can create unlimited opportunities. They are smart about the investment decisions they make, even though not all of their investments pan out they way they would like, but they know that investment brings rewards and they are willing to risk now to reap rewards later. Small business owners, like farmers, understand the law of the harvest -- we reap what we sow. Farmers would never dare not to sow the seeds of the crops they hope to harvest next fall. Likewise, small business owners know that an investment today, if it is a good one, will pay off tomorrow.

Over the years, small business owners have, more times than not, had to help themselves to get ahead. Banks have often been reluctant or unwilling to loan them money, refusing to bet on a promising idea and a practical dreamer. This has deterred some from pursuing their dreams, but it has not deterred the rest -- the bold risk-takers -- who have bet everything on themselves and their dreams and their ability to achieve them. It is government, more times than not, that has not extended a helping hand to small business owners as they have sought to invest in new companies to create jobs and growth for themselves and their communities. Government policies, including tax policies, have been one of the greatest obstacles in the path of small business owners. In fact, tax policies have acted as a disincentive for savings and investment -- the sources of capital entrepreneurs need to start and expand companies. For example, the current tax treatment of capital gains has hurt investment as well as the small business owners who spur growth and the many millions who benefit from it.

That is why it is important that this Committee do something about the tax policies that have inhibited growth. These policies have punished both those who are willing to save and invest and those who help create businesses and the jobs and growth our nation needs.

Like many small business owners, ambition, determination, and hard work have carried me far. I have been helped by my own faith and the blessings that come from it. And, I might add, I have had my share of good luck and fortune along the way. But as any smart small business owner will tell you, it is investment that drives business growth and productivity. In 1989, I started my company -- R&IB -- a full-lines insurance brokerage company. When we opened our doors in July we had five employees and rented a small executive suite. Since money was tight I had to finance my company's operations from its cash flow. This same cash flow also provided the investment funds we needed to grow.

I made a commitment to invest from the beginning. Then I searched for the best talent I could find, and I invested in the technology that our employees needed to work faster, smarter and better than our competitors. Soon I moved our company from rented rooms into newly acquired space so that we would have room to expand and provide quality service to our customers. I increased training for employees to keep giving them the skills they needed to succeed in their jobs. In fact, I invested in anything that would give us an advantage.

Some five years later, I am pleased to say my company has grown from five employees in rented space to more than 110 employees in our own commercial space. We now have several offices, and our growth continues.

What has been the secret of this success? Well, to agree with several critics, I would admit that luck has played a role. But more than that so has hard work, determination, tenacity, customer service, and many other factors. The decisive factor that has helped to fuel our growth has been a continuing commitment to investment. Our future growth will also continue to depend on and come from investment. Without it, I cannot envision that our company will long remain as successful and as profitable as it has been in the years since its creation.

Many other small business owners could recount similar success stories. They have been fortunate enough to finance their own growth through cash flow or from the generosity of friends and family, through personal savings, or from bank loans. But many others have been unable to attract the investment they need. Others have been taxed with such a heavy hand that it has diminished the return on investment. I believe small business owners can do more with a dollar than most other businesses can do with three. Isn't it time that Congress begin to remove the impediments to savings and investment and the obstacles to investment in small businesses that pay for themselves many times over?

I believe that the neutral cost recovery provisions are a good start to help small business owners recover more of the dollars that they invest in plants, equipment, and technology. These investments help build strong and prosperous companies that employ local residents. Because inflation is not taken into consideration and is not figured as part of the write-offs, small business owners are unable to recover the real value of their investments. Inflation always chips away at this value. Another problem is that the write-off does not take into account the time value of money. This also reduces the present value of an investment. As a small business owner, I endorse the neutral cost recovery proposal because I believe that there is a fundamental issue of fairness at stake here. I believe these provisions will help to correct an inequity in the current tax treatment of write-offs as they relate to recovery of the full value of investments in depreciable assets.

From my perspective as a small business owner, I can see how this new recovery provision will help spur additional business investment and could lead to new advances and improvements in productivity. This will also mean higher wages for employees. It is wrong to suggest that an investment helps only the individual who makes it. In my years of experience, whenever my company invested in computer equipment, in a building or in any other asset, many benefited from that investment. I believe these recovery provisions will indeed spur economic growth, and new job creation through increased investment.

Over the years, many small business owners have taken advantage of the expensing write-off. This has been a benefit to many small business owners. But in many cases, the write-off has not been as helpful as many intended it to be. I am pleased to see that the Committee has proposed that this expensing provision be increased $7,500, up to $25,000, on the first $200,000 in investment. This is an important change and, one that, I believe, will help promote investment at the local level and increase economic growth and job creation.

By passing the proposals we have discussed today, this Committee can help small business owners to start and expand companies. Their efforts will result in jobs for Americans and products for the world. The incentives that will encourage savings and investment are the very ones that will promote economic growth.

I'm a simple businessman, but I take pride in the fact that I employ a lot of people and many families depend on a business I started from scratch. I've met thousands of small business owners across this great country who have also created this American dream, and thousands who want this same opportunity for themselves.

Won't you help them by helping to create this opportunity? I know they will help others and eventually help support this great country. Won't you give them increased incentives and breaks that I could have used and know that they can? Small business owners are optimistic about the future, and if we can help them invest in their dreams, we will all benefit.

With 700,000 new businesses started each year in this country there are men and women in every state brimming with new ideas and energy to make new companies work. I saw a film last year that touched my heart, and obviously millions of others. It was Forest Gump, and even though he was possibly not as bright as everyone else around him, with hard work and diligence, and yes, some lucky breaks, maybe even breaks created by Providence, he created a business that helped support many families. Yes, it is a film fantasy, but it is a fantasy that comes true every day in this country. It is the American dream of starting and owning a business, and I think that is one of the reasons that this film touched so many hearts. I ask you to help keep this American dream going.

I appreciate this opportunity to offer my views on the important tax and investment incentives contained in the Job Creation and Wage Enhancement Act.

Mr. McCRERY. Thank you, Mr. Rumfelt.

I thank all of you gentlemen for your excellent testimony and bearing with us through a long day of hearings.

Mr. Hancock, would you like to inquire?

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Chambers, I was not here for your testimony, but I am specifically interested in the rent-to-purchase industry. That primarily is small business individuals. Is there a national company, a large organization engaged in that business? Is there a franchise operation? Have they started franchising this type of business?

Mr. CHAMBERS. Yes, Congressman. The industry itself is comprised primarily of mom and pops, what we classify as owner-operators. About 80 percent of the businesses are that way of the 7,500 stores that we have. There is one larger group that operates. It is commonly called Rent-a-Center, and that is probably the largest group that we have.

Mr. HANCOCK. You don't happen to know how many stores they operate?

Mr. CHAMBERS. Not off the top of my head. I would assume it is somewhere in the thousand-store range.

Mr. HANCOCK. I understand that there has been a little bit of a problem showing up all of a sudden about whether a rent-to-own is actually a lease-purchase, or whether it is a sale. And Internal Revenue, as I understand, in some instances, has decided that when you sign a lease, that that is a sale and that the entire value of that lease is income and that you should pay income taxes on it.

Mr. CHAMBERS. Yes, sir, that is correct. We feel it is a lease primarily because it has a terminability clause and no obligation on the part of the customer. The Service, for example, has decided that if a piece of merchandise is rented, let's say, on December 25, and the tax year ends on December 31, and the customer makes a $15 payment, what they want us to do is accrue all the future income associated with that agreement back into the current tax period and tax it accordingly. That puts a tremendous burden, tax burden on the taxpayers, one of which most of the companies involved in our industry would not be able to fund and survive.

Mr. HANCOCK. OK. Let me understand this. I want to be sure this gets in the record. You sign, let's say, a 5-year contract on merchandise, and let's say, it is $50 a month, which would be a total of $3,000 that they will pay you over a 5-year period in rentals if, in fact, they pay the full 5 years.

You sign the contract for a Christmas present, and on December 24, let's say in 1994 you signed this, you would be required to declare in that year the full $3,000 as income, even though all you had been paid is $50?

Mr. CHAMBERS. Yes, sir, that is correct. And taxed upon that amount.

Mr. HANCOCK. Now, 6 months from now there is no overhead expense or anything else. That would be pure profit, except finance charge.

Mr. CHAMBERS. They allow us to deduct the cost of the merchandise—which is minimal.

Mr. HANCOCK. If they want to handle it that way, could they carry it one step further and deduct the cost of the merchandise from the profit rather than make you capitalize it?

Mr. CHAMBERS. That is correct.

Mr. HANCOCK. Are they doing the entire rental business that way now or are they just doing it in specific cases?

Mr. CHAMBERS. Well, Congressman, over the last 2 or 3 years, there has been a heightened audit activity upon our particular business. And most of the audit activity, I would say probably somewhere in the range of 80 to 90 percent of the audit activity, deals with the issue that you are speaking of. And as they audit the dealers throughout the country, they are, in fact, making them or asking them, to recognize all future revenues back into the current period and tax it accordingly. And in a lot of cases, they are assessing penalties and interest because they feel as though the taxes were not paid appropriately the first time.

Mr. HANCOCK. That is going to put some of those operations out of business.

Mr. CHAMBERS. I would venture to say someone like myself it would definitely put out of business. I am a small businessman within the industry, and I would say it would put probably 80 to 90 percent of the small businessmen in the industry out of business because banks will loan us money to buy merchandise to create revenues but they will not loan us money to pay taxes on income not yet received.

Mr. HANCOCK. We know what happened to the banking industry when they started having to book high-income loans that defaulted. We know what happened to that industry a few years ago. Well, thank you very much. I would like to talk with you further or to your organization or whoever is representing you, about how we can work something out in the regulations to at least be fair on the basis of a cash business. You haven't received the money, therefore, you have not made the profit. You have a paper profit and that is all.

Mr. CHAMBERS. That is it, yes, sir. The future money that we would hope to receive is still out there. We have that one payment that you spoke about.

Mr. HANCOCK. And I understand according to history, you are going to have 10 percent of those customers just vanish with the merchandise.

Mr. CHAMBERS. That is correct. Over a period of, roughly, 12 months, somewhere in the neighborhood of 10 percent of the merchandise will be lost, stolen, poorly used and abused, and come back in an unrentable situation.

Mr. HANCOCK. And under these laws, you would have paid income tax on it, even though you cannot find those people.

Mr. MCCRERY. Thank you, Mr. Hancock.

I think you made the point. And there are several of us here who would like to help you get that straightened out.

Ms. Dunn.

Ms. DUNN. Thank you.

Mr. Chambers, I would like to ask you another question. How would your industry, the rental-purchase industry be affected if we were to adopt in H.R. 9, the neutral cost recovery provisions that we are talking about, without adopting the cost recovery rules for the rental-purchase business?

Mr. CHAMBERS. Congresswoman Dunn, the H.R. 9, the adoption of H.R. 9 would not exactly help us in terms of as it relates to NCRS. We are looking at H.R. 9 being a place where if we are going to talk about depreciation law and the equitable administration of the depreciation laws, particularly for our industry, this is the place that we need to talk about them.

As a layman and a businessman, I am not an attorney or CPA, I am only a businessman, the only place I have, in my experience with the IRS and with the courts out there, the only place left for me to come, is to a forum as this is say, as a small businessman, I need help. I don't know where else to go to get the help.

Ms. DUNN. As a layman to a businessman, the reverse probably, why do customers choose to engage in a rental-purchase transaction, rather than a retail sales transaction?

Mr. CHAMBERS. Really for three simple reasons: For the convenience of it. If they come into our locations, they can generally have the merchandise the same day.

Second, most of our customers come to us because they don't want to have a continuing obligation placed upon them.

And third, customers come to us because we don't do credit checks and we don't extend credit. A lot of these customers come to us because for some reason or another we are not the judge of that. They may be uncreditworthy and they can't go to a retail operation and get the proper financing in order to get the goods.

Ms. DUNN. Thank you.

Thank you, Mr. Chairman.

Mr. MCCRERY. Thank you, Ms. Dunn.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Callahan, can you explain how the alternative minimum tax system works against the normal business cycle or why is the alternative minimum tax particularly troublesome during recessionary times?

Mr. CALLAHAN. I heard the first part, you may have to restate the second part. If you look at the mechanics of the AMT over the business cycle and you look at the add-backs that lead you into AMT and the tax itself when you are in the low end of the business cycle and profits are down, the add-backs that lead you to the calculation of paying an AMT don't change and go down with your profitability. So you can find yourself in the bottom of the business cycle, paying almost the same AMT because of the add-backs and preference items that get you to that calculation. And, therefore, you are not stimulated in the bottom of the cycle to invest your way out. It is a bit of a trap on the bottom.

Mr. COLLINS. The situation would be even worse in recessionary times.

Mr. CALLAHAN. Yes, and I am speaking of recession——

Mr. COLLINS. Your cash flow goes down, but your tax liability stays level.

Mr. CALLAHAN. Yes, sir.

Mr. COLLINS. What are the advantages of simply conforming the alternative minimum tax depreciation system to the current system used for regular taxpayers rather than conforming the system to the proposed neutral cost recovery system?

Mr. CALLAHAN. Well, probably the biggest of those is to put us all on the same basis. If you look in the industries we compete in, we can find ourselves against a competitor in the same industry, where they would be a regular taxpayer with the 5-year depreciation and we would be an AMT taxpayer with almost twice the length of that recovery period, 9, 9½ years, within the same industry by two corporations. You can have two recovery periods of A versus B competing in the same industry.

So, the biggest single reason to put the two together is to have a level playingfield in the same industry; and second, it would make it simpler in terms of running two separate depreciation systems, the regular and the AMT system, both from a corporate point of view—figure it out, what to pay, and also from the IRS point of view. Recent studies have been pretty clear in their comments and with their documentation of the cost of collection under such a complex system. Both of those depreciation systems just add to the complexity of the whole tax system; but the biggest reason is to put all taxpayers on the same tax basis.

Mr. COLLINS. Thank you, sir.

Mr. Rumfelt, some have expressed that the neutral cost recovery system would really cause some complexity to the depreciation schedules. Is the neutral cost recovery system really worth it? Is it too complex?

Mr. RUMFELT. I think for the benefit of small business, that right now it is the opportunity that is on the table. And it is something or other that is being proposed, and certainly has advantage for most small businessowners, to some degree.

And, of course, there is some criticism with regards to the method of which this is calculated as being complicated and cumbersome, but I also have to rely on the wisdom of our congressional representation to simplify this so that small business can understand it and CPAs can deal with the issue.

I am not certain that is enough clarification, but I think the issue at hand is certainly a starting point. I think it is something that we can build upon and it is certainly going to have a positive impact on the 22 million small businessowners throughout America.

Mr. COLLINS. Well, as you say, it is a starting point.

We have had a lot of testimony today dealing with alternative minimum tax, and I am very pleased to hear some colleagues from the other side of the aisle speak very favorably about making some changes to alternative minimum tax, which I think would be very beneficial to the business world and also to jobs.

I thank each of you for being here.

Mr. MCCRERY. Mr. Christensen.

Mr. CHRISTENSEN. Thank you.

Mr. Ross, in your testimony you touched on the fast-changing semiconductor world and how quickly things become obsolete. Can you describe for the committee the decline in value of the semiconductor, how quickly it is changing, and how would this neutral cost recovery system affect your association?

Mr. ROSS. I hear several questions in that question, but I think there are two very important responses. The semiconductor industry is, as has been stated, a very fast-moving industry. And the example that I like to use—one that is common knowledge to most of us—is the microprocessor. In the past 5 years, we have all become accustomed to the term 286, and 386 and 486, and now the Pentium. These products have all arisen, and except for the Pentium and the 486, have died within a 3- or 4-year period.

We have seen product cycles where 10 years ago a 286 was in production for 4 years. The Pentium will be in volume production for less than 2 years. The cycle is shrinking.

Now, these products are infinitely more complex today than they were 5 or 10 years ago. The functionality on the integrated circuit has increased by order of magnitude factors of 10 every 2 or 3 years, and as a result, the equipment required to produce them has had to keep pace with this increase in functionality.

Now semiconductor products typically come into the market selling for a fairly high price. However, competitive pressures force the reduction in the average selling price, the ASP, as we refer to it in our industry, by 10 or 15 percent per year. That is sort of bad news, but the good news is that the American semiconductor community has learned how to reduce cost at a faster rate than the ASP deteriorates every year.

The neutral cost recovery system impact is on the semiconducting manufacturing equipment, the effect of which is twofold: First, it has the effect of eliminating the double-declining balance depreciation method. And if enacted may have the actual result of reducing the current level of 20 percent per year depreciation to 15 percent. So we are going in the wrong direction here in terms of the global competitive reality that we face.

We are competing with companies who in some cases are depreciating equipment over a 1 to 1½ year period.

Mr. CHRISTENSEN. When Speaker Gingrich and Majority Leader Armey introduced the bill in the previous years, I was not around here. I am new to Congress and to this committee. How did that do on vote totals? Do you know?

Mr. ROSS. I personally do not know. Counsel advises me that it has never been formally considered for a vote.

Mr. CHRISTENSEN. It was locked up in committee, maybe? And do you know what committee that was in?

Mr. ROSS. Ways and Means.

Mr. CHRISTENSEN. Ways and Means? Amazing. I wonder if there is anything we can do to get it out.

We thank you for your testimony.

Mr. ROSS. The questions were excellent.

Thank you for the opportunity to address them.

Mr. MCCRERY. Mr. Coyne—this is the last—thank you.

Mr. Chambers, one quick question. With respect to the item that Mr. Hancock was asking you about with respect to the interpretation by IRS that the lease agreement really amounts to a sale and you have to pay taxes on the full amount of the object that you are leasing. Has that always been the case?

Mr. CHAMBERS. No, that has not always been the case. That has surfaced since 1986 when they changed the Tax Code and did away with the installment sales accounting provision. It has surfaced more readily in the last 3 to 4 years, however. It has become the number one topic, the audits, as they do the audits on the industry.

Mr. McCRERY. So this is a problem that is just now coming to the fore.

Mr. CHAMBERS. A fairly new problem and a very significant problem.

Mr. McCRERY. Thank you all gentlemen for your excellent testimony. We appreciate very much your being with us today.

[Whereupon, at 4:37 p.m., the hearing was adjourned, to reconvene at 10 a.m., Tuesday, January 31, 1995.]

SAVINGS AND INVESTMENT

TUESDAY, JANUARY 31, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. If we could ask our guests to take seats. Today's hearing will consider the portion of the Contract With America concerning the American dream savings account. We all realize that in the last several years, our savings rate in the United States has been entirely too low. The low savings rate adversely affects our standard of living, as well as business' ability to compete in the global marketplace.

The Contract With America has several tax incentives intended to stimulate savings, investment and growth. One of those incentives is the American dream savings account. It is unique and innovative in the way that it uses the current IRA provisions. It appeals to a broad range of taxpayers by granting preferential treatment for distributions that are used for such desirable purposes as educating one's family, purchasing a first home, or meeting emergency medical needs.

By granting tax benefits to distributions that are for worthy purposes, it encourages a broad spectrum of taxpayers to use the dream savings account. The American dream savings account also encourages owners of existing IRAs to transfer their current IRA account balances to the American dream savings account by granting these transfers special tax treatment.

One criticism has been that the dream savings account is backended; that is, the tax benefit is delayed until the funds are withdrawn. In contrast, the current IRA, which would continue to be available, is called frontloaded because the tax benefit is granted when the contribution is made. However, in a recent Boston Globe article, my good friends and noted economists Martin and Kathleen Feldstein noted that the American dream savings account can produce as much benefit as the traditional frontloaded IRA. I hope that some of our witnesses today will comment on this aspect of this new approach. I ask unanimous consent to make the Feldsteins' article a part of the record.

[The following was subsequently received:]

Opinion

Good news for savers

MARTIN FELDSTEIN AND KATHLEEN FELDSTEIN

THERE IS GOOD NEWS FOR SAVERS IN the Republican Contract with America. A key promise of the contract is for a new and better kind of individual retirement account (IRA) called the American Dream Savings Account. Since President Clinton has now signaled his willingness to support these new IRAs, it seems a sure bet to pass in the early months of the new Congress.

The increased saving that the American Dream program is likely to generate in the years ahead means that the new accounts will be good for economic growth as well as for individual savers.

The favorable tax treatment of savings made IRAs popular and led to their rapid growth after Congress authorized them in 1974. But the Tax Reform Act of 1986 sharply limited eligibility by excluding taxpayers with incomes over $50,000 (or $35,000 for single taxpayers) who participate in a pension at work.

The new legislation will give every employee the opportunity to have an ADS account that is actually a better deal than the traditional IRA. And those who are currently eligible for a traditional IRA will be able to have both the traditional IRA and a new ADS account as well.

The new ADS accounts are more appealing than traditional IRAs because funds can be withdrawn without penalty for spending on first-time home purchases, higher education and medical care. There is, however, a difference in the timing of tax savings that causes some skeptics to doubt whether the new ADS accounts will be as popular as the traditional IRAs. Unlike the immediate tax saving that results from a deposit in a traditional IRA, the tax savings in the ADS is "backloaded" and not immediately visible. The two methods are nevertheless really equivalent dollar for dollar in their value to a taxpayer. Moreover, the backloaded ADS accounts actually provide the opportunity to save a larger percentage of pretax income on favorable terms.

To understand why, let's look first at the rules of the two plans and then at an example of how they would work in practice. Under the traditional IRA an eligible individual can deposit up to $2,000 a year and get an immediate tax break by not having to pay income taxes on the amount that is deposited in the IRA. The earnings on those savings in the form of interest, dividends and capital gains accumulate free of tax. When the funds are withdrawn, the taxpayer pays income taxes on the initial deposit as well as on all the accumulated earnings.

In contrast, the ADS account offers no immediate tax break but the accumulated funds in the account are free of all tax when they are withdrawn. The maximum individual contribution would again be $2,000, but it would have first been counted in taxable income.

To see why the two methods are really dollar-for-dollar equivalent, let's look at an example. Consider a 45-year-old employee with a marginal tax rate of 28 percent who decides to put $1,000 into a traditional IRA. If that saving is invested in a long-term bond yielding 8 percent and accumulates until the employee withdraws the funds at age 75, the initial $1,000 grows to an amazing $10,062. If the funds are withdrawn at that point, the employee will pay a 28 percent tax on the total accumulated savings, or $2,817. That leaves the employee with $7,245, on an initial investment of $1,000.

But the employee didn't really give up the chance to spend $1,000 at the time of the initial deposit. If that money had not been put into an IRA, the individual would have had to pay taxes of $280 before using the money for consumption. So one way to interpret the traditional IRA is to think of the individual giving up $720 of consumption today to get $7,245 of consumption 30 years from now.

Now think about what would happen to the same individual who puts savings into an American Dream Savings account after paying income taxes on his or her full income. Putting an after-tax $720 into an ADS account means giving up the same amount of current consumption as putting $1,000 into a traditional IRA. If the savings are invested in the same way and withdrawn at age 75, the $720 in the ADS account will have grown to $7,245. And since no further taxes are due, the actual spendable return on the ADS account is indeed exactly the same as in the traditional IRA.

Because depositing $720 in an ADS account produces as much retirement consumption as $1,000 deposited in a traditional IRA, while the limit on contributions is $2,000 to either plan, the new ADS plan has the advantage that savers can accumulate more retirement income with the new ADS plan than with a traditional IRA.

We're sold on the new ADS accounts as an attractive way to encourage saving. We're also convinced from studies of the experience with traditional IRAs that such accounts do raise the national saving rate even if the loss of tax revenue causes the budget deficit to rise. So the new ADS accounts are indeed a good place to begin a legislative shift to policies that favor capital formation and growth.

Martin Feldstein, the former chairman of the Council of Economic Advisers, and his wife Kathleen, also an economist, write frequently together on economics.

Chairman ARCHER. I now recognize our colleague, Jim McDermott, for an opening statement on behalf of the minority.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I ask unanimous consent to revise and extend my remarks.

I think you can tell by the number of Democrats here how much we think this hearing really means. Clearly, the minority believes that the majority is going to roll a bill out of here with no language, no numbers, and it really is the American dream. I think that this might best be called the peyote savings account act, because when I was a kid, I remember opening my first bank account; and the bank gave away Lincoln heads, and you could put your pennies in those Lincoln heads and you could save and some day, if you put your pennies in that head, you were going to be wealthy and live happily ever after.

Now, in a society where, increasingly, people do not have pensions, in which 1 million people every year are losing their health insurance, in which there is no long-term care in a society where everybody is living longer and longer—our medical system has created a population that is living well into their eighties—and in which higher education is costing so much that even physicians come out of medical school $150,000 in debt, to say that you can put a little bill through the Congress here and reestablish the American dream is simply nonsense.

I come from the party that provided Social Security, that provided loans for houses, that provided the GI bill of rights, that provided a whole series of public programs that made the American dream possible, and most of us in this room, my generation especially, were the beneficiaries of these programs on 1,000 different levels.

Now, what this says is—and you have got to remember, this is in a context where we already have IRAs for people earning less than $35,000 in income for singles, and $50,000 for couples. We are talking about extending IRAs up to the top of the income ladder in this country. It is simply a benefit for rich folks. These new ADSAs are not going to change the lives of the people in this country that are struggling with the American dream. Because in Seattle today, if you want to buy a house, a starter house costs more than $100,000 in Ballard, which is the area where you start, or Wallingford, so that means you have got to come up with ten grand.

Now, if you are making $35,000, raising a family and trying to come up with ten grand, using this IRA as the basis for buying that house simply is never going to make it. Most of us know that our children—my kids are 28 and 26—will not buy houses unless their father or their mother can back the loan for them, or put up the downpayment. And to say that you are going to create this savings account is simply giving them a dream, albeit everybody ought to have a dream, but there ought to be some reality to it.

The reality of this is that in this Congress we are going to pass this bill out with this "dream savings account" in it at the same time that the Appropriations Committee is sitting over in another building cutting Medicare, cutting Medicaid, cutting student loans, cutting HUD—all the programs that make it possible for people to actually participate in the American dream.

And I say that this committee will be fools to pass this bill out if they don't know how it is going to be paid for. Because if you are going to balance the budget and cut taxes, as this does, and give people tax savings or benefits without understanding what the cuts are in the rest of budget, you are simply putting the American dream further out of people's reach.

For that reason, Mr. Chairman, most of the members of the Democratic side didn't bother coming, because this is just plain smoke and mirrors.

Thank you.

Mr. THOMAS. Mr. Chairman.

Chairman ARCHER. Without objection, any members who would like to enter a written statement in the record may do so. I believe Mr. Thomas wishes to do that.

Mr. THOMAS. Thank you, Mr. Chairman. This would be in support of H.R. 682, which is the companion bill to Senator Roth's S. 12. Thank you very much.

[The opening statements follow:]

STATEMENT OF THE HON. BILL THOMAS
COMMITTEE ON WAYS AND MEANS
January 31, 1995

Mr. Chairman, I am pleased that the Committee is finally getting an opportunity to consider restoring the savings incentives provided by the Individual Retirement Account. The "backloaded" IRA covered by the Contract With America is a good start but we should consider going beyond that and adopting the "Super IRA" proposal Congressman Neal and I introduced last week. Our bill, H.R. 682, is much like the "Super IRA" provisions many members of this Committee and of the House supported when they were included in H.R. 11 in 1992. Now, more than ever, we need to consider those provisions.

H.R. 682 provides a range of savings options for taxpayers to use and it eliminates a key concern some younger taxpayers feel when considering whether to open one of these accounts. H.R. 682 will phase out the income limits on making deductible contributions to IRAs, give homemakers the option of creating an IRA as large as that available to one working outside their home and creates a "backloaded" IRA like the Contract's so taxpayers can invest net income in return for tax-free earnings later on.

The need to expand savings is clear. Americans typically save less than people in other countries and the effect is to reduce families' security. A Merrill Lynch survey shows half of American families have less than $1,000 in net financial assets. Even those within ten years of retirement (ages 55 to 64) only have $6,880 in net financial assets such as checking, savings, IRAs or 401(k) savings.

Another survey shows that the 76 million Americans in the "Baby Boomer" group are saving at rates far below what they need to maintain their standard of living after retirement. When we consider the prospect that Social Security may run out of funds early in the next century, the security of the Baby Boomers looks poor indeed. We need to develop savings incentives that will make them more secure. I strongly support the use of the Individual Retirement Account for that purpose.

Tax-preferred savings accounts such as IRAs and 401(k) plans do increase savings. Viewed on a long term basis, taxpayers do contribute new savings to these accounts when the accounts are made available. While some "shuffling" of existing savings into tax deferred accounts may occur, one study indicates that as much as 66% of IRA investments comes from new savings. Few people have enough liquid assets to continue shuffling assets from one type of savings into tax-preferred accounts for very long.

A 1991 Money Magazine reader survey confirms the popularity of the "super IRA" truly is with the people we want to serve. An unusually high 23,000 Money readers responded to the survey. 97% said they would contribute to IRAs if IRAs were restored; the remaining 3% were largely already retired. 80% said they would contribute earned income, new savings, to their IRA. IRA popularity cuts across all income groups and people were more interested in IRAs than in capital gains.

The Money survey also shows why young people do not use IRAs today: risk avoidance. While many of the respondents indicated they were not inclined to make early withdrawals, some three-quarters of the respondents in their 20s says they do not use IRAs because they do not want to lock away funds they cannot touch in emergencies or in meeting critical family needs. The super IRA, with its elimination of the 10% early withdrawal penalty for withdrawals for education, medical costs, buying homes, long-term care and times of unemployment, provides a savings vehicle which gives working families the liquidity they want. At the same time, it provides a savings vehicle taxpayers cannot easily invade to fund current consumption of consumer goods.

H.R. 682 provides savers with a variety of incentives and options. People deserve choices in managing their money and I hope my colleagues will join me in seeking H.R. 682's passage this year.

Jim Ramstad

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA

Mr. Chairman, as I have stated at several of these hearings, I am deeply concerned about our nation's declining savings rate.

The United States household saving rate compares miserably to that of our partners in the Group of Seven industrialized nations (G-7). In 1993, the U.S. household saving rate was just <u>half</u> that of the next lowest G-7 member, at 4.4%.

Relieving the tax burden on those who invest in IRAs will prompt Americans to save more of their income than they currently do. I firmly believe that in addition to enacting tax policy that encourages rather than discourages saving, we must keep that policy in place over the long-term. Nothing is more frustrating and disheartening to American taxpayers than constant changes in the tax code that severely limit their ability to plan for the future.

I am pleased we have a panel of distinguished experts to discuss these issues today.

I thank you all very much for being here today and look forward to your testimony.

Chairman ARCHER. Senator Roth, you are our first witness today, and we are delighted to have you over here on the House side. I know that you, early on, were one of the initiators of the back-ended IRA. We welcome your testimony.

STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM THE STATE OF DELAWARE

Senator ROTH. Well, thank you, Mr. Chairman and members of the Ways and Means Committee. It is particularly a pleasure to be here today with our new chairman. I appear before this committee to testify concerning the need to encourage increased savings in America.

I believed back in April 1989 when I last testified before this committee, as I do now, and as Federal Reserve Chairman Alan Greenspan has since confirmed, that our national savings crisis is the key domestic economic policy problem of this country.

A few months after offering that testimony, in an effort to increase our Nation's rate of saving, I introduced a little-known proposal referred to as the backloaded IRA. And my idea was rather simple. By offering Americans an individual retirement account, an IRA that would allow them to determine when to take their tax break, we would encourage savings, investment and economic growth; and at the same time, we would decrease our dependency on foreign capital, and we would ease somewhat the tax burden that was growing on the backs of middle-class Americans. Little did I know that in 1994, House Republicans would move forward with this same basic IRA plan, including it in their popular "Contract With America." Indeed, this is an idea whose time has come, and I am here today to offer strong encouragement for this new kind of savings account, the backloaded IRA.

In the Senate, I have reintroduced my original legislation, S. 12, now called the "Roth-Breaux super IRA." Companion legislation has been introduced here in the House by Congressmen Bill Thomas and Richard Neal (H.R. 682), both members, of course, of this committee. This is encouraging, as is the fact that well over half of the Senate has cosponsored this legislation in each of the last two sessions of Congress. In fact, even the President of the United States has joined us.

Indeed, the savings issue appears to be getting the attention it deserves. And I believe the reason why is clear: America's rate of personal saving is last among the G–7 nations. Between 1992 and the present, the rate has plunged from 6 to 4 percent, translating into a drop of personal savings of $100 billion. At the same time, taxes have steadily increased, consuming more than 40 percent of the average family's income, when we consider Federal, State and local obligations.

The IRA I introduced will not only create powerful incentives to increase our Nation's rate of savings, but it will provide tremendous tax benefits. It will give all Americans the option to choose between tax-deductible contributions, traditional frontloaded IRAs, or contribute to a new backloaded IRA. Contributions to this new type of IRA would not be deductible, but earnings would not be taxed when they are withdrawn. It is important to note, Mr. Chairman, that under our bill, these IRA contributions, contributions up to the full $2,000, can also be made by all spouses who work at home.

By making IRAs more available and more attractive, we address four pressing national problems: The extremely low U.S. personal savings rate; the lack of capital for investment, economic growth and job creation; the high tax burden carried by American families, including the double taxation of savings; and the lack of family resources to pay for higher education expenses, home purchases and medical care costs. Each of these areas will be improved with the super IRA.

We will increase the rate of personal savings. This increase in savings will stimulate economic growth. As Professor Henry S. Rowen of Stanford explains, an increase in the net national savings rate by 5 percent of GDP would increase real wages of the next generation by about 15 percent above its trend, a major increase.

By giving American families tax incentives to save, we will offer a very productive and beneficial way to ease some of the tax burden they are now carrying. And to help our families pay for necessary costs, like first-time homes, education and medical bills, our proposal allows family members to make penalty-free IRA withdrawals across generations to help other family members.

Mr. Chairman, my time has expired, but I would ask that my full statement be included as if read.

Chairman ARCHER. Without objection, your entire statement will be included in the record; and we appreciate your testimony.

Are there any questions, anyone that would like to question? Raise your hand.

Thank you, Senator.

Senator ROTH. Thank you, Mr. Chairman. It was a pleasure to be here.

[The prepared statement and attachment follow:]

SENATOR WILLIAM V. ROTH, Jr.
WAYS & MEANS COMMITTEE TESTIMONY
AMERICAN DREAM SAVINGS ACCOUNT
JANUARY 31, 1995

Mr. Chairman and Members of the Ways and Means Committee, in April of 1989 -- almost six years ago -- I appeared before this committee to testify concerning the need to encourage increased savings in America. I believed then, as I do now -- and as Federal Reserve Chairman Alan Greenspan has since confirmed --that our national savings crisis is "the key domestic economic policy problem of this country." A few months after offering that testimony, in an effort to increase our nation's rate of saving, I introduced a little-known proposal, referred to as the "backloaded" IRA.

My idea was rather simple: by offering Americans an Individual Retirement Account, an IRA that would allow them to determine when to take their tax break, we would encourage savings, investment and economic growth. At the same time, we would decrease our dependency on foreign capital. And we would ease, somewhat, the tax burden that was growing on the backs of middle class Americans.

Little did I know then that in 1994, House Republicans would move forward with this same basic IRA plan, including it in their popular "Contract with America." Indeed, this is an idea whose time has come, and I'm here today to offer strong encouragement for this new kind of savings account -- the "backloaded" IRA.

In the Senate, I have re-introduced my original legislation -- S. 12 -- now called the "Roth-Breaux Super IRA." Companion legislation has been introduced here in the House by Congressmen Bill Thomas and Richard Neal (H.R. 682), both members of this committee. This is encouraging, as is the fact that well over half of the Senate has co-sponsored this legislation in each of the last two sessions of Congress. In fact, even the President of the United States has finally joined us. Indeed, the savings issue appears to be getting the attention it deserves!

And I believe the reason why is clear: America's rate of personal savings is last among the G-7 nations. Between 1992 and the present, the rate has plunged from six percent to four percent, translating into a drop of personal savings of about $100 billion. At the same time, taxes have steadily increased, consuming more than 40 percent of the average family's income, when we consider federal, state and local obligations.

The IRA I introduced will not only create powerful incentives to increase our nation's rate of saving, but it will provide tremendous tax benefits. It will give all Americans the option to choose between tax deductible contributions to traditional "frontloaded" IRAs, or contribute to a new "back-loaded" IRA. Contributions to this new type of IRA would not be deductible, but earnings would not be taxed when they are withdrawn. It's important to note, Mr. Chairman, that under our bill, these IRA contributions -- contributions up to the full $2,000 -- can also be made by <u>all</u> spouses who work at home.

By making IRAs more available, and more attractive, we address four pressing national problems: (1) the extremely low U.S. personal savings rate; (2) the lack of capital for investment, economic growth and job creation; (3) the high tax burden carried by American families, including the double taxation of savings; and, (4) the lack of family resources to pay for higher education expenses, home purchases and medical care costs.

Each of these areas will be improved with the Super IRA. We will increase the rate of personal savings. This increase in savings will stimulate economic growth. As Professor Henry S. Rowen of Stanford explains, "An increase in the net national savings rate by five percent of GDP would increase real wages of the next generation by about 15% above its trend, a major accomplishment!"

By giving American families tax incentives to save we will offer a very productive and beneficial way to ease some of the tax burden they are now carrying. And to help our families pay for necessary costs like first-time homes, education and medical bills, our proposal allows family members to make penalty-free IRA withdrawals across generations to help other family members. Parents and grandparents can help children and grandchildren; children and grandchildren can help parents and grandparents.

This is how we should be preparing for the future, by adopting legislation that provides incentives for self-reliance, thrift, investment and economic growth. Strengthening the Individual Retirement Account will do just this. And I appreciate the strong support we're seeing toward achieving these objectives.

Mr. Chairman, I thank you for the opportunity to testify before you on this important legislation. I would ask that you also include a copy of a side-by-side comparing the provisions in the American Dream Savings Account with the provisions in the Roth-Breaux Super IRA. Thank you.

COMPARISON OF INDIVIDUAL SAVINGS PROVISIONS IN THE SAVINGS AND INVESTMENT INCENTIVE ACT OF 1995 (S. 12) AND THE CONTRACT WITH AMERICA (H.R. 6)

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Prepared by the Staff of the Joint Committee on Taxation
January 30, 1995

CONTENTS

INTRODUCTION

This document, prepared by the staff of the Joint Committee on Taxation, provides a comparison of individual savings provisions of present law; the Savings and Investment Incentive Act of 1995 (S.12), introduced by Senator Roth and Senator Breaux on January 4, 1995; and the American Dream Restoration Act (H.R. 6), introduced by Mr. Crane and others on January 4, 1995, as part of the Contract with America.

Item	Present Law	S. 12	Contract With America (H.R. 6)
L. **Deductible IRA contributions**	An individual may make deductible contributions to an IRA up to the lesser of $2,000 or the amount of the individual's compensation if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). If the individual is an active participant, the $2,000 limit is phased out between $40,000 and $50,000 of AGI for married taxpayers and between $25,000 and $35,000 of AGI for single taxpayers.	Income limitations:--The bill would increase the AGI limits for IRA deductions for active participants in 1995, 1996, 1997, and 1998. Thereafter, the bill would repeal the limits on IRA deductions for active participants. In the case of married taxpayers, for years before 1999, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1995, $65,000 and $75,000; for 1996, $90,000 and $100,000; for 1997, $115,000 and $125,000; and for 1998, $140,000 and $150,000. The bill would also provide that a person is not considered an active participant merely because his or her spouse is an active participant in an employer-sponsored retirement plan. In the case of single taxpayers, for years	The bill would retain present law.

Item	Present Law	S. 12	Contract With America (H.R.6)
		before 1999, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1995, $50,000 and $60,000; for 1996, $75,000 and $85,000; for 1997, $100,000 and $110,000; and for 1998, $125,000 and $135,000.	
		Coordination with elective deferrals:--The bill would provide that the IRA deduction limit for any individual is coordinated with the limit on elective deferrals to section 401(k) plans (and similar plans). Thus, an individual's deductible contributions to an IRA and elective deferrals could not exceed the annual limit on elective deferrals.	
		Effective dates.--The phase up of the income limits and the rule providing that an individual is not an active participant merely	

Item	Present Law	S. 12	Contract With America (H.R.6)
		because the individual's spouse is an active participant would be effective for years beginning after December 31, 1994. The repeal of the limits on deductible IRA contributions for active participants would be effective for years beginning after December 31, 1998. The coordination of the IRA deduction limit with the limit on elective deferrals would be effective for years beginning after December 31, 1994.	
2. **Inflation adjustment for IRA deduction limit**	The $2,000 limit on IRA contributions is not indexed for inflation.	The bill would index annually the $2,000 limit on IRA contributions in $500 increments. **Effective date.**--The limit on IRA contributions would be indexed beginning after 1995.	The bill would retain present law.

Item	Present Law	S. 12	Contract With America (H.R. 6)
3. **Spousal IRAs**	In the case of a married individual whose spouse has no compensation (or elects to be treated as having no compensation) the $2,000 limit on IRA contributions is increased to the lesser of $2,250 or the individual's compensation.	Under the bill, the compensation of both spouses would be taken into account in determining the IRA deduction limit for each spouse. Thus, a couple would be permitted to make up to a total of $4,000 of IRA contributions (up to $2,000 for each spouse), if the aggregate compensation of the couple is at least $4,000. **Effective date.**--The provision would be effective for years beginning after December 31, 1994.	The bill would retain present law.
4. **IRA investments in coins and bullion**	IRAs are not permitted to invest in certain collectibles. The acquisition by an IRA of a collectible is treated as a distribution in an amount equal to the cost of the collectible. Collectibles are defined as any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or any other	The bill would permit IRAs to acquire any (1) coin certified by a recognized grading service and traded on a nationally recognized electronic network or listed by a recognized wholesale reporting service and which is (or was at any time) legal tender in the country of issuance or issued under the laws of any State, or	The bill would retain present law.

Item	Present Law	S. 12	Contract With America (H.R.6)
	tangible personal property specified by the Secretary of the Treasury. The prohibition on investment in collectibles does not apply to certain U.S. commemorative gold and silver coins or coins issued under the laws of any State.	(2) gold, silver, platinum, or palladium bullion, if the coin or bullion is in the possession of the IRA trustee. **Effective date.**--The provision would be effective for years beginning after December 31, 1994.	
5. **Nondeductible tax-free IRAs**	No provision. (However, present law does permit individuals to make nondeductible contributions to an IRA to the extent an individual is not permitted to (or does not) make deductible contributions. Earnings on such contributions are includible in gross income when withdrawn.)	In general.--The bill would repeal the present-law rules relating to nondeductible contributions and replace them with new provisions that permit individuals to make nondeductible contributions to IRA Plus accounts.	In general.--The bill would permit individuals to make nondeductible contributions to an American Dream Savings (ADS) account.
		Contribution limit.--An individual could make contributions to an IRA Plus to the extent they do not make deductible contributions to an IRA.	Contribution limit.--The maximum annual contribution that could be made to an ADS account would be the lesser of $2,000 or the individual's

Item	Present Law	S. 12	Contract With America (H.R.6)
		For this purpose, the active participant rules and the rule coordinating IRA contributions with elective deferrals would be disregarded in determining the maximum deductible IRA contribution the individual is permitted to make.	compensation. This amount would be in addition to any contributions that may be made to present-law IRAs. The $2,000 limit would be indexed annually for inflation beginning in 1996. Inflation adjustments would be rounded to the nearest $50.
		<u>Contributions for nonworking spouse.</u>--The compensation of both spouses would be taken into account in determining the contribution limit for each spouse.	<u>Contributions for nonworking spouse.</u>--Same as S. 12.
		<u>Contributions after age 70-1/2.</u>--The bill would not permit contributions to be made to an IRA Plus account after age 70-1/2.	<u>Contributions after age 70-1/2.</u>--The bill would permit contributions to be made to an ADS account after age 70-1/2.
		<u>Taxation of distributions.</u>--Distributions would not be includible in income to the extent attributable to contributions that have been in the IRA Plus	<u>Taxation of distributions.</u>--Distributions would not be includible in income if the distribution (1) is made at least 5 years after the individual first

Item	Present Law	S. 12	Contract With America (H.R. 6)
		account for at least 5 years. The bill would provide rules to determine how earnings are allocated to contributions made at different times and ordering rules to determine the order in which contributions are withdrawn.	made a contribution to any ADS account and (2) is (a) made on or after the date on which the individual attains age 59-1/2, (b) made to a beneficiary after the death of the individual, (c) attributable to the individual's being disabled, or (d) is for the purchase of a first home, higher education expenses, medical expenses, or long-term care insurance premiums.
		Rollover contributions.--The bill would permit amounts withdrawn from IRAs to be transferred into an IRA Plus. The amount transferred would be includible in gross income in the year the withdrawal was made, except that amounts transferred to an IRA Plus before January 1, 1997, would be includible in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to	Rollover contributions.--The bill would permit amounts in IRAs to be rolled over to an ADS account if the rollover occurs before January 1, 1998. The amount otherwise includible in income due to the IRA withdrawal would be included in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to such rollovers.

Item	Present Law	S. 12	Contract With America (H.R. 6)
		amounts transferred from an IRA to an IRA Plus.	
		Effective date.--The provision would be effective for taxable years beginning after December 31, 1994.	**Effective date.**--The provision would be effective for taxable years beginning after December 31, 1995.
6. **Other**	A 10-percent additional tax applies to distributions from IRAs and tax-qualified retirement plans made before age 59-1/2, unless the distribution is on account of death or disability or is made in the form of periodic payments. In the case of tax-qualified retirement plans, the 10-percent additional tax also does not apply to distributions made to an employee after separation from service after age 55 or to distributions used to pay medical expenses of the employee and his or her dependents that exceed 7.5 percent of AGI.	The bill would exempt from the early distribution tax distributions from IRAs, elective deferrals (and earnings thereon) under qualified cash or deferred arrangements, and tax-sheltered annuities used for first-time home purchase or education expenses. In addition, the bill would expand the exception for extraordinary medical expenses so that it applies to expenses of all children and grandchildren of the employee or the employee's spouse and all ancestors of the employee or the employee's spouse, whether or not they are a dependent for income tax purposes. The bill also would exempt from the tax	No provision.

Item	Present Law	S. 12	Contract With America (H.R. 6)
		distributions from IRAs to persons who have been receiving unemployment compensation for at least 12 weeks. **Effective date.**--The provision would be effective for distributions after the date of enactment.	

Chairman ARCHER. Our next two witnesses are Senator Kay Bailey Hutchison from the State of Texas and Senator Barbara Mikulski from the State of Maryland. If you would like to take seats at the witness table, we would be pleased to hear from you.

Is Senator Mikulski here?

Senator HUTCHISON. I have not seen her this morning. She was planning to come when I talked to her yesterday. I am sure she will be here, and I hope that she makes it before we finish.

Chairman ARCHER. Senator Hutchison, we are delighted to have you before our committee. We know that you have taken the lead in moving for homemaker IRAs. We would be pleased to hear you tell us about that. You may proceed.

STATEMENT OF HON. KAY BAILEY HUTCHISON, A U.S. SENATOR FROM THE STATE OF TEXAS

Senator HUTCHISON. Thank you, Mr. Chairman. I am very pleased to be here with you as chairman of the Ways and Means Committee. I have worked with you and known you for a long time, and I know you are going to do a terrific job for the people and the taxpayers of America.

I want to add another dimension to the bill that you are discussing now, and I hope that you will be able to add homemakers into the present system in the bill before you today. It would mean a lot to the homemakers of America to know that the Congress of America has acknowledged that work done inside the home is every bit as important as work done outside the home, if not more so.

This bill would just very simply—and let me say that Senator Mikulski and I are the prime cosponsors in the Senate, a similar bill has—in fact, an exact bill has been introduced in the House by Congresswomen Nancy Johnson, Jennifer Dunn, Barbara Kennelly, and it—it is a very bipartisan effort. We have 57 sponsors in the Senate at this time, and I believe that there is really no one who is against this bill.

What our bill would do is allow homemakers simply to set aside $2,000 a year, just as those of us who work outside the home are able to do. Today, under current law, a single-income, married couple saving $2,250 per year, which is the maximum, for 30 years would have $188,554 for retirement if you assume 6 percent average interest. But if that couple is permitted to save $4,000 a year, after 30 years they will have $335,207, an increase in savings of almost $150,000.

According to the Bureau of Labor Statistics, 23 percent of all women over the age of 16 are married homemakers. So it is obvious that their retirement needs for their families are the same as two-income earner couples. In fact, their needs may be greater; because the homemaker stayed home to raise the children, a single-income couple may have earned less money to set aside for the future. We can help them meet that need by enacting this legislation.

Everyone knows that women go in and out of the work force at a greater rate than men, because they have children. Many times they stay home for a few years, so they don't have the total accumulation that people who work outside the home continually would have. So I think it is very important that we acknowledge that this is a matter of equity and it is good economics. Although there is a modest cost in the bill, right now about $55 million per year, for which we can suggest offsets—but I know that you are aware of all of the offsets that could be gotten——

Chairman ARCHER. Don't be bashful, Senator.

Senator HUTCHISON [continuing]. But for $55 million a year, I actually think if we had dynamic scoring, it would be a net plus, not a minus, because we all know if you have more capital formation, that creates more jobs which creates more revenue. So I hope that you will look at this as a matter of equity and a matter of good economic policy.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF UNITED STATES SENATOR KAY BAILEY HUTCHISON

COMMITTEE ON WAYS & MEANS
HOUSE OF REPRESENTATIVES

January 30, 1995

Mr. Chairman, thank you very much for allowing me and my colleague, Senator Barbara Mikulski of Maryland, to appear today. Last Thursday, Senator Mikulski and I, along with 55 co-sponsoring Senators, introduced a bill that will allow the homemakers of this country to make fair, fully deductible Individual Retirement Account contributions. Representatives Johnson, Kennelly, and Dunn introduced identical legislation in the House. The bills will allow equal IRA contributions by Americans that work at home -- women, and a growing number of men, who have suffered unfairly under an out-of-date section of the tax code.

Under the current IRA rules, single-income married couples are limited to a deductible IRA contribution of $2,250 each year; $2,000 for the working spouse, and $250 for the homemaker. But if both spouses in a household work outside the home, each is permitted to contribute up to $2,000 annually to an IRA -- that's a combined contribution of $4,000. The bill does not change the current pension limitation of section 219(g), which phases-out the deductibility of IRA contributions for married active participants in retirement plans if they earn more than $40,000 a year.

Under current law, a single-income married couple saving $2,250 each year for thirty years will have $188,554 for retirement, at six percent interest. If that couple is permitted to save $4,000 a year, after 30 years they will have $335,207 -- an increase in savings of almost $150,000.

According to the Bureau of Labor Statistics, 23% of all women over the age of sixteen are married homemakers. It's obvious that their family's retirement income needs are the same as a two-income couple's. In fact, their needs may be even greater -- because the homemaker stayed home to raise the children, a single-income couple may have earned less money to set aside for the future. We can help them meet that need by giving them the incentive and opportunity to save.

Women have longer life expectancies than men, and make less money for the same work. They leave work to have children and care for their families, and then return to find that they have fallen behind on their retirement savings. With lower pension and social security benefits, homemakers have much less for retirement. We must not deny them their best opportunity to save.

I support many of the tax policy changes that have been proposed this year, including expanding IRAs. But before we expand IRAs or make other changes, we need to make IRAs fair. We must permit homemakers to save, like all other Americans, for their retirement.

It is time the Congress recognizes that work done inside the home is as important as work done outside the home, if not more so. I urge the Committee to include this legislation in the Contract tax bill so that American homemakers can begin saving this year.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Senator.

Senator Mikulski, we are delighted to have you with us this morning, and we would be pleased to hear your testimony, and you may proceed.

STATEMENT OF HON. BARBARA A. MIKULSKI, A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MIKULSKI. Thank you very much, Congressman Archer. It is a delight to come before the Ways and Means Committee, and I congratulate you on your chairmanship and look forward to working with you, both on the IRA equity for homemakers, as well as the super IRA, because I feel one of the most important national objectives we must accomplish is to encourage savings and investment and to give, if you will, "good guy" and "good gal" bonuses to ordinary, middle-class people. That is why I am delighted to join with my colleague, Senator Kay Bailey Hutchison, and members also of the Ways and Means Committee on the IRA Equity Act for Homemakers.

Ladies and gentlemen of the Ways and Means Committee, all women work. Work is work, whether it is done inside the home or outside the home. Senator Hutchison has given a very clear and concise and crisp discussion of this legislation, and I just want to amplify why it is important that we do it.

The Hutchison-Mikulski bill in the Senate has stayed simple and to the point. Why? What we want to say is this: Homemakers who stay at home work. They perform some of the most important and valuable work that is done in the United States of America, child rearing. In this, equity demands that they get the same IRA opportunity as their income-earning spouse.

This legislation accurately reflects their values. It gives help to those who are willing to practice self-help through saving. It acknowledges the value of motherhood and the work that is done in the home as being important to the American society.

Not all work is done in the marketplace. Productivity in the workplace is the result of the work of mothers in the home, preparing America's workers and leaders. We often don't count what counts. The gross domestic product just looks at the marketplace. We need to stand up and count the work that goes on in the home.

Motherhood has always been important and today we are saying it is absolutely important. When we say, honor your father and your mother, it should not only be a commandment, but a public policy. The law should be clear that moms and dads will be rewarded—will not only be rewarded now, but in their future and in their retirement years. Current rules of government do not support this. The Hutchison-Mikulski bill acknowledges the pattern of women working in and out of the marketplace.

This is an empowerment strategy for women. Many women work some time in the marketplace, are at home for child rearing, and then back in the marketplace. This essentially constitutes a portable benefit package for them. They don't have linear careers, they don't follow that pattern where, once in the marketplace, they stay in the marketplace. So what we are able to do is analyze that situation and see that often when it comes to retirement, because women take time out to be in the home, or always stay in the home, they don't have a pension plan; and if they do, it is spotty, erratic and most often skimpy.

This is not a recipe for a relaxing Gucci retirement. It is a plan to make sure that ordinary women who choose to be in the home—or men, because it is not gender identified—will be able to give help to themselves and practice self-help.

So, Mr. Chairman, I am going to leave my testimony here for you. I have gone into it in great detail. But I like this because it accomplishes several national goals, and I am happy to join with the architect of the legislation, Senator Kay Bailey Hutchison.

Chairman ARCHER. Without objection, both of your statements will be inserted in the record in their entirety.

[The prepared statement follows:]

News from
Senator
Barbara A. Mikulski
of
Maryland

FOR IMMEDIATE RELEASE
January 30, 1995

CONTACT: ERIN CALLAHAN
RACHEL KUNZLER
(202)224-4654

**STATEMENT OF SENATOR BARBARA A. MIKULSKI
ON IRA EQUITY LEGISLATION**

I am delighted to work on a bi-partisan basis with Senator Hutchison again to pass IRA Equity legislation.

Work is work, whether it is done inside the home or outside the home. And we should reward work. With this legislation we do.

I like this legislation because it reflects our values; it gives help to those who practice self-help.

It acknowledges the value of motherhood and it acknowledges that work done in the home is important to American society. Not all work is done in the marketplace. A substantial amount of the most important work of America goes on in the home.

This legislation will provide the same IRA tax deduction to stay-at-home moms and dads as is available now to those who earn an income.

Current law allows workers to set aside up to $2000 a year in an IRA -- but only if they get an income. So two-income couples can contribute $4000.

But one-earner couples, where one spouse stays home to raise the kids, well, the best they can contribute to their IRA each year is $2250.

Our IRA Equity bill says every couple gets the full $4000 contribution. Period.

Motherhood has always been important. Today we're seeing it's absolutely important.

I believe that when we say honor your father and your mother it should not only be a commandment, but a public policy. The law should be clear that mom and dad will not only be rewarded now, but in the future, in their retirement years.

For someone whose work is as a full-time mom, it's not only an occupation, it's a pre-occupation.

When we're talking about productivity in the workplace we need to remember that the work of mothers today is preparing America's workers and leaders of tomorrow.

Often in our society we don't count what counts. We look at the Gross Domestic Product, we look at what is done in the marketplace, but what is not counted is what is done in the home or what is done as volunteer work.

I happen to believe that one of the most important areas of productivity is the work that goes on in the home.

The current rules of government do not support this. We see this in the rules governing pension plans. And we continue to see inequity for women in the workplace in many ways, like bringing home smaller paychecks.

This is important pro-family legislation. It truly acknowledges the value of the family. It gives help to those who practice self-help. And it builds strong communities.

It also acknowledges the pattern of women as they work in and out of the marketplace. Many women do not have linear careers, with glittering resumes, tickets being punched and revolving rolodexes that take them on the path to glory.

Most women do the ordinary with enthusiasm, whether its raising their family or raising the productivity of the private sector in the marketplace. But because they work, and have their children, and return to the marketplace, often their pension plans are spotty, erratic, and most often, skimpy.

That is not a recipe for a relaxing retirement, but a plan for poverty.

Passing this legislation not only offers a measure of fairness and hope, it just makes good sense. It --

-- boosts our national savings,

-- helps women have the opportunity for a comfortable retirement, and

-- strengthens our commitment to family values.

I support this legislation because I want to put our values into pragmatic public policy, and I am pleased to join with my colleagues on a bipartisan basis to reward hard-working Americans.

I will continue to fight for passage of IRA Equity because it's time Congress puts the law where our values are.

# # #

Senator HUTCHISON. Mr. Chairman, could I add one thing?

Chairman ARCHER. Surely.

Senator HUTCHISON. We have a broad range of support for this bill from the American Association of University Women, the Business and Professional Women, the Concerned Women of America, the Eagle Forum and the Women's Political Caucus, among others. So I think that there is a broad range of political support, as well as support for the concept on the merits.

Chairman ARCHER. I think the fact that you and Senator Mikulski are sitting there side by side, both embracing this, is pretty good evidence that there is bipartisan support.

Senator MIKULSKI. We are pals.

Chairman ARCHER. Let me ask you, does your bill apply to all income levels? Can anyone qualify, irrespective of their annual taxable income?

Senator HUTCHISON. Yes, within the current law caps. We don't change current law, so that deductibility depends on the total income of the single-income earner family.

Chairman ARCHER. So you would limit it only to people under $35,000 a year, as under the current law?

Senator HUTCHISON. Well, for the deductibility, but of course anyone can contribute to an IRA, whether it is deductible or not.

Chairman ARCHER. So that is current law?

Senator HUTCHISON. Yes. It does not change current law.

Chairman ARCHER. OK. So you have a current law which permits a nondeductible $2,000 contribution, and you would add a deductible contribution. I assume that that would be in lieu of the $2,000 nondeductible contribution, or would it be in addition thereto?

Senator HUTCHISON. No, Mr. Chairman. This does not change current law standards. Everything that applies today would apply in the future. The one-income-earner couple's joint income would be the test for deductibility or not. So I am not adding deductibility where we don't now have it.

Chairman ARCHER. But what I am trying to determine is whether this would permit a $2,000 nondeductible and an additional $2,000 deductible?

Senator HUTCHISON. No.

Senator MIKULSKI. Mr. Chairman, just to clarify, under current law, a $2,000 contribution can be made. For the spouse at home, if you wish to add the spouse, you are capped at only being able to contribute $250, so it would be $2,250.

This would allow a $2,000 and a $2,000. The deductibility would only apply according to whatever standards the Congress ultimately decides, what will be the standards for deductibility.

Chairman ARCHER. How high could the family income be before you would not qualify for this new benefit?

Senator MIKULSKI. Whatever is in current existence would be that. And also if—in the super saver legislation, which I know the committee is considering, if it raises the income levels for deductibility, this will go by the same rules of the game as you establish for IRAs generally.

Chairman ARCHER. So this would go right along with the American dream savings account provision insofar as any limit to deductibility based on taxable income?

Senator MIKULSKI. That is right.

Senator HUTCHISON. Right. There is no change.

Chairman ARCHER. Senator Mikulski, did I understand you to say that you support the American dream savings account?

Senator MIKULSKI. No, I didn't support the American dream savings account. I said I supported legislation related to a super IRA, but I would hope that we could find common ground and bipartisan support on this, because we must encourage savings; there is no doubt about that.

The capital needs of the world when one sees what they are—even in our own country we must encourage capital formation. And we need—and that capital formation is going to come not only from big institutional accounts like pension plans, but ordinary people saving through ordinary instruments of savings in our country, whether it is savings accounts, CDs, mutual funds, the good old American way. I want to give help to those who are practicing self-help. And that is why I would support raising the income deductibility limits and what we can do to encourage that.

Chairman ARCHER. How would you distinguish between the super IRA and the American dream savings account?

Senator MIKULSKI. Well, Mr. Chairman, I am not prepared to answer that today, because I don't have my side-by-sides with me. But I don't want the headline news to be tomorrow that "Mikulski Supports the American Dream IRA."

I support the American dream, and then what the legislative framework will be, I think will be arrived at through bipartisan negotiation.

Chairman ARCHER. Well, my understanding is that there are differences between the American dream savings account and the super IRA.

Senator MIKULSKI. I am sure there is. I just haven't focused on the precise details this morning. I have already had two meetings in the commute from Baltimore. I wish all that was aerobic.

Chairman ARCHER. Thank you very much. Are there any questions from members?

Mrs. Kennelly.

Mrs. KENNELLY. Yes, thank you, Mr. Chairman.

The other night we heard Mr. Clinton really embrace IRAs. We have heard two Senators, in a bipartisan manner, embrace IRAs; and Ms. Dunn and Mrs. Johnson and I are sponsoring this bill on the House side. And, Mr. Archer, I understand you are going to let us move forward if at all possible, if it fits in the plans.

How are we doing, Mr. Archer?

Chairman ARCHER. How are we doing on moving this forward? Well, the committee, of course, will take action on this when we get into markup.

Mrs. KENNELLY. Thank you, Mr. Archer.

Chairman ARCHER. Mrs. Johnson, Ms. Dunn and yourself may offer an amendment to include this in the Contract, and it will be duly considered.

Mrs. KENNELLY. I thank you for this hearing, Mr. Archer.

May I just put on the record some of the figures that Mrs. Hutchison cites with regard to why this is a good idea?

Chairman ARCHER. Yes.

Mrs. KENNELLY. Yes.

[At the time of printing, no information was received.]

Chairman ARCHER. Apparently we have a number of people that want to question, so we will do it in the regular order.

Mr. Thomas.

Mr. THOMAS. Thank you very much, Mr. Chairman.

I want to thank both of you for this obvious plus in addition to the whole concept of IRAs. I think at this stage, it is less useful to talk about the American dream IRA, or the super IRA, and talk about the fundamentals. Senator Mikulski, I want to thank you for the statement you made about the fundamentals of the saving concept.

The gentleman from Washington prior to your arrival indicated that the reason there weren't very many Democrats here was that he believes that this is all smoke and mirrors. I was going to make a comment about the fundamental difference between the two parties, that we really believe that somehow creating incentives for people to put their own money away is not only good public policy, but it is very smart public policy, and that, frankly, it is very much a part of the American dream. The legislative process will work out what that particular format is.

I am a cosponsor, original—was with Senator Bentsen and Jake Pickle in the old days of the super IRA—and pleased to share with Roth and Breaux and Richard Neal on this side. Your comments I think are really critical, because one of the things that I have noticed among homemakers is a concern, in a relative sense, about a sense of worth and that they know they are important and doing a good job. I have had a number of discussions with friends whose wives choose not to work, and the idea of getting a monthly statement in which savings have been put away in their name and seeing the growth of that amount is, I think, a very strong reinforcer of their worth. Your approach, especially the difference in dollar amounts—clearly at the maximum end of someone's income, but translate these into a middle income—is nevertheless a clear reinforcer of worth, getting these monthly statements. I want to compliment you for making sure that we focus on that aspect of the American dream.

I invite any comments. Have you had folks talk about the reinforcement aspect of a savings account like the IRA that you are asking for?

Senator HUTCHISON. Absolutely, Congressman. I appreciate your bringing that out, because it is one of the important ways that we can say to the homemakers of America how important the work they do is; and this does quantify, if you will, what they will be able to build up.

And let me say that this works for families or for broken families. If a single-income-earner family stays together, they have taken a loss in income through their working lives, and this gives them a chance not to lose the security in their retirement years. But if it is a broken family, if a homemaker loses her husband, either through death or divorce, she then has that security which is denied her without this opportunity to set something aside in her own name. That is her security for retirement years. And this is perhaps the greatest need that we have for divorced mothers who have not been in the workplace. So it is a win-win situation from every standpoint, and I thank you for bringing that out.

Mr. THOMAS. Thank you very much, Mr. Chairman.

Chairman ARCHER. Mrs. Johnson.

Mrs. JOHNSON. Thank you, and I welcome my colleagues and commend you on the leadership you have provided on this issue, and we look forward to joining you in advocacy of the homemaker IRA as we move this process forward.

I think it is important to focus on the difference between the bill you are advocating and the American dream savings account, and that is the issue of deductibility. Nondeductibility makes it harder, and the American dream savings account is a nondeductible contribution. There are some very real benefits from it and it is a wonderful idea, but in terms of helping homemakers and particularly young couples, helping women, early, to save, you really need that deductibility, a family needs to be able to get that.

And I thank my colleague from California for putting so clearly the ownership issue. Women in America, partly because of the security of today's world, do need from very early in their life to have their name on retirement benefits. So it is not just the portability, it is the ownership; and deductibility in this sector is critical to being able to make that second contribution. And I really thank you for your testimony here today, and I commend you on your leadership.

Senator HUTCHISON. Well, thank you for your help and leadership from the beginning on this. I really appreciate it.

And I also think that the difference is, which Mr. Archer mentioned, it is front-end deductibility or back-end deductibility; and I think having the range of choices is very important. The American dream can go hand in hand with the present system and people can choose what is best for them, and it is like a cafeteria of options. And I think adding this to the present system—and I know the American dream accounts are gender or homemaker neutral—this would just add another option that is able to be gotten for homemakers that is not now on the books and wouldn't be even in the future without this amendment.

Mrs. JOHNSON. Right. In other words, a lot of those who would benefit from your bill simply couldn't benefit under the American dream savings account, because they wouldn't have enough assistance in savings.

Senator MIKULSKI. Congresswoman Johnson, I think you have outlined a very serious issue in terms of the deductibility. Congresswoman—Senator Hutchison and I wanted to be very careful that when we proposed this idea 2 years ago—this was really Senator Hutchison's first and prime legislative initiative when she came to the Senate, and I was the first on the other side of the aisle to join with her, for all of the values that we said we wanted to achieve.

We were also very mindful of the deficit, to be careful that we wouldn't run into a buzz saw of opposition, that we would be adding to the deficit, so we were very careful to keep within the current law related to deductibility. As the Congress works on the super saver and the American dream savings account and someone looks at the deductibility issue, again, we didn't want to be defeated under the guise of the deficit. So that is why we put ourselves within that framework.

The policy concerns that you have raised are the same that Senator Hutchison and I and all of the cosponsors have, particularly where there is a single wage earner. So that is an important point.

But I just want to make one other point about the so-called American dream restoration or super saver. The other aspect that I like is that while the homemaker is at home and has her IRA, at such time where she might choose to return or enter the marketplace, she would then have the ability to turn to this as an educational expense.

If I think of a homemaker who has been at home, her kids are now through school, and guess what? They are tuition poor, because about the time she is ready to return to the marketplace or enter the marketplace, they have hefty tuition bills for higher education. But if she chose to study being a paralegal or something, that would be right there for her; she could borrow and—then I am sure quickly—be able to quickly repay it. Also, for long-term care in the future.

Mrs. JOHNSON. That is really an excellent point, because most women who stay home and take care of their children, particularly if they end up staying at home 10 or 15 years really do need to go back to school and would need the resources to do that.

Senator MIKULSKI. I know the red light is on, and there are women—Kay Bailey and Barb Kennelly and Jennifer Dunn—and Roscoe Bartlett backing this; this is an incredible alliance.

But I just want to say this, that we need to show that this legislation really helps women help themselves. We are in a postrights era, and the most important right, though, that you can have is the right to be able to take care of yourself in your old age and prepare for education.

Mrs. JOHNSON. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you both, Senators. And Barbara, welcome back home, and I want you to know that I look forward to supporting this amendment to the American dream.

One of the very few benefits of being in the minority, unlike it was for us last year, is that we don't have to worry about paying for anything, because that is done through scoring mechanisms; and so even though I was excited about the deficit being reduced for the third time in 3 years—the first time since Harry Truman—we will have the luxury here of perfecting a bill that we can all vote for, all of the popular things. And I can't wait to vote for the $500-per-child tax credit that costs us in 10 years $288 billion.

Another exciting provision is the neutral cost recovery; that is only $120 billion over 10 years. The most exciting, really, I guess, everyone would know is the capital gains tax preference; and that is only $183 billion over 10 years. Of course, these are only U.S. Treasury Department estimates. I am certain the majority will have something far more exciting to come up with.

But under the Treasury, the dream savings account in its present form is $17.7 billion, and of course the additional contribution, which I support, will increase that.

I am not certain, because the Chair hasn't advised us yet, but it appears as though after we excitedly support all of these parts, then we would vote on the total package. And that is where we are going to have a problem, because like someone said on the other side, you keep putting together these billions and pretty soon you are dealing with real money.

But I would want you to know that you can count on my support for the inclusion, but I don't know where I am going to be during the markup when this is finally over. But thank you both for your contribution.

Chairman ARCHER. The gentleman from Kentucky, Mr. Bunning will inquire.

Mr. BUNNING. No questions.

Mr. THOMAS [presiding]. Mr. Herger. Mr. Herger is not here.

Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I want to echo the remarks of Mr. Rangel. I think all of us are looking forward to voting for all of the good things and leaving the cutting to the Republicans, because I think that turnabout is sort of fair play. We will have a really great session on this side of the aisle, we will vote for it, just because it is a good idea; there ought to be equity.

But what I am concerned about is, what do you think the likelihood is that this can be paid for in the Senate? We sort of lose touch with what is going on over there, and I keep wondering if you have any feeling for whether or not you will be able to make 20- to 30-percent reductions across the board. If you take Social Security and Medicare and defense off of the table, will they be able to balance the budget in the Senate? Can you get the votes up for a 20- to 30-percent cut on the rest of the budget?

Senator MIKULSKI. If you can balance it in the House, we will be able to balance it in the Senate.

Senator HUTCHISON. Let me say that, yes, I do think we can, and I think it is a matter of setting a budget and then prioritizing. And I would just say, Congressman, that in the lists of priorities, I think equity in IRAs for homemakers would be at the top of the list.

Now, I have suggestions of potential cuts that could be used, but they could be used for the entire bill, and I am sure that you will make those choices. But I just think we have to say, like every other home, every business, every State and local government in this country, that we can set a bottom line and then determine what the priorities are within that framework. And if I were voting, one of the priorities that I would have would be savings incentives, and I think adding homemakers into the mix is a matter of equity.

Mr. MCDERMOTT. Senator, if you—you heard the array that Mr. Rangel put forward of things that are being proposed in that body, and I wonder if you could rank them in order for me, which of those things do you think is most important? Would you think the $5,000 deduction for adoptions would be the most important, or the $500 credit per child, or this particular proposal you are making? Would you say this proposal is more important than the $500 per child or the $5,000 for adoption or the capital gains proposal? If we have to make tough choices here, which item would you put first?

Senator HUTCHISON. Well, not surprisingly, I would put equity for homemakers and retirement security right at the top of the list. But I also think, Congressman, that phasing in is an option that we are all going to have to look at. And I would rather phase in this equity, just as I would phase in tax credits for children or other very good proposals that you might determine. But I think we will find when we phase in that these are things that will add to the economy, not take away.

I truly believe that there will be a benefit, not a detriment, to revenue if we encourage savings. So if we phase it in, I think we will be able to reap that benefit as we go.

Senator MIKULSKI. Congressman McDermott, you raise a very important issue, and I think that whatever legislation we come out with, it should have the fundamental goals that we wish to achieve in our society—one of which, of course, is truly to reward work and work among the working poor. That is why I would hope that no matter what we do, we would keep the earned income tax credit and think how we will even strengthen that as we move to welfare reform, so that we can reward work and make sure that for the working poor, work pays.

The second public policy assumption should be that we should be stimulating savings over consumption, and therefore, whatever the legislative framework is that stimulates savings should do that.

When we look at issues relating to the family and help—giving help to those who wish to practice self-help, the deduction, the allowance, if you will, for children does need to be changed. The children's deduction has been held constant even though inflation has been a significant issue.

I joined with Dan Coats last year in increasing the deduction for children, because I think that is important. But if you get to a $200,000 limit on that as income, I think that is excessive. I think once you reach $200,000, you are beyond being ordinary, middle class. So I think that income level would need to be changed.

In terms of encouraging adoption, I don't think people need a tax deduction for adoption. What I find is that among Maryland families, people are willing and eager to adopt children, particularly childless couples. The issues are the at-risk children and also the rules that get into the very complicated issue of interracial adoption. So it is not that people need—the middle-class people I know that are willing to go to Russia, willing to go to Romania, willing to go to Argentina, Chile, Peru, Brazil to adopt children don't need a $5,000 tax credit; they need other types of help. And for those other American families that wish to adopt, we need to work at the adoption rules for the at-risk children that often prevent people who wish to adopt children from being able to adopt them.

Mr. THOMAS. The gentleman's time has expired.

Mr. MCDERMOTT. Thank you.

Mr. THOMAS. The gentlewoman from Washington, a cosponsor of the bill.

Ms. DUNN. Thank you, Mr. Chairman. Yes, as an original cosponsor in the House on this legislation, I want to commend the two Senators for their leadership in pushing this issue, keeping focus on this issue; and just tell you that the important points of the IRA Equity Act, I believe are its focus on values that we hold dear, the value of giving credence and standing to the people who stay at home and raise our children and care for our elderly; or who do volunteer work in the community, which we need to focus on much more seriously as we look toward the new operation of programs like welfare, for example; or who are retraining themselves during a phase in their life when they need to be at home and not employed in the workplace; and also the value of equity to folks who are staying at home and to women who are working in the home.

I think it also achieves that goal that this committee has supported, and that is so important, which is to increase savings in this Nation. I do want to inform the Senators that in a meeting where I was present with Republican women Members they showed great enthusiasm for this legislation. I expect that we will be able to increase our sponsors very considerably in the next few days, and I also believe that it is a responsibility that comes down to us when we find how we are going to fund this program.

I believe that we will find the sources. I have some sources in mind that I want to contribute, Senator Hutchison, to your list; and I look forward to working with you on this very important legislation.

Senator HUTCHISON. Thank you for your leadership, Congresswoman Dunn.

Chairman ARCHER [presiding]. I am delighted to hear all of these gratuitous offers of extra revenue. We will certainly find a use for all of them as the year goes on.

Senator HUTCHISON. Mr. Chairman, as long as you don't take them and then not put our amendment in the bill, that will be fine.

Chairman ARCHER. Well, I am sure that the proponents who will offer the amendment will carefully craft it.

I am curious, though. We had an opening statement, Senator Mikulski, from our colleague, Congressman McDermott in which he said he basically didn't think that we ought to give IRA opportunities to people who had incomes over $35,000, because that would be giving money to the rich. I believe that is what the gentleman from Washington said; I don't want to quote him incorrectly.

But your support of the super IRA would eliminate all of the——

Mr. MCDERMOTT. If the gentleman will yield——

Chairman ARCHER I just hope that you can have some influence over our colleague, Mr. McDermott, so he will go along with us.

I will be happy to yield to the gentleman from Washington.

Mr. MCDERMOTT. If you recall, I said at the end of my statement that I am for all of these good things, I support everything, as long as we can pay for it. And I stand ready when you show us where you are going to get the money.

However, if you are going to ruin all of the things that you are trying to fix with the IRA, it simply doesn't make sense to me. And I am willing to support these things as long as you can come up with a balanced budget—and I was pleased to hear Senator Mikulski say if we can balance it, it will pass in the Senate. We look forward to seeing your budget and your numbers.

Chairman ARCHER. Well, I can assure the gentleman that we will offset any tax reductions with spending cuts, and the gentleman can put that in the bank. So I am glad that he supports——

Mr. MCDERMOTT. In my piggybank?

Chairman ARCHER. I am glad that he supports the concept, irrespective of the earnings limit.

Are there any other members who would like to question the witnesses?

We thank you very much. Both of you have made excellent presentations to the committee this morning.

Senator MIKULSKI. Thank you very much. It is good to see old colleagues, and new Members that I hope to become better acquainted with.

Senator HUTCHISON. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you.

Our next witnesses are two of our colleagues in the House, Congressman Bill Orton of Utah and Congressman Bill Baker of California. If you will take seats at the witness table.

Congressman Orton, you will be our first witness, and we will ask you to keep your oral presentation under 5 minutes. Without objection, your written statements will be made completely a part of the record in their entirety. Congressman Orton, you may proceed.

STATEMENT OF HON. BILL ORTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH

Mr. ORTON. Thank you, Mr. Chairman. I have submitted a detailed written statement with several exhibits to explain some of the technicalities of how my proposal would actually function.

Mr. Chairman, members of the committee, I very much appreciate the opportunity to testify before you today. The goal of increasing savings and investment is critical to our country's long-term economic prospects. I commend you for calling this hearing.

Mr. Chairman, study after study have demonstrated that the most significant barrier to home ownership in this country is the high level of downpayment generally required to secure approval of a mortgage loan. Yet, because of our current tax laws, the $850 billion currently invested in individual retirement accounts are effectively precluded from being used for such downpayment purposes, either directly by a homeowner or through a parental loan. I have come before you today to advocate changes to these laws to dynamically open up this $850 billion of assets and put them to work to promote home ownership.

Yesterday, I reintroduced the First-time Home Buyer Affordability Act in this Congress. It is H.R. 726. I have been working on this legislation for over 3 years. It was introduced in the previous two Congresses. The last Congress, H.R. 1149, was a bipartisan effort with 28 cosponsors, almost equally split between Republicans and Democrats, including the distinguished chairman of the Rules Committee, Gerald Solomon. It was also endorsed by both the National Association of Home Builders and the Mortgage Bankers Association of America. The bill that I filed yesterday is virtually identical, with a few minor perfecting changes.

I would like to take just 1 minute to explain to you the need for this legislation. Current IRA statutes prohibit an IRA accountholder from engaging in a number of what are called "prohibited transactions," including loans to family members and one's own personal use of IRA funds. If anyone uses IRA funds for a prohibited transaction, the penalties are severe. The money that is used is subjected to full taxation at the State and Federal levels, plus a 10 percent premature withdrawal penalty. Combined, that can equal over 50 percent of the money withdrawn. The result is that, under current law, individuals are effectively precluded from using IRA funds to make a downpayment to buy a home.

My legislation overcomes this barrier by providing a targeted exemption of the prohibited transaction rules to allow individuals to access IRA accounts to make a downpayment on a first-time home purchase.

Specifically, my bill permits individuals to borrow money from their own IRA account to make all or part of a downpayment for a first-time home purchase of a primary residence. This is similar to loans permitted right now from one's 401(k) account.

It also permits parents to lend money within their IRA account to their children for the use of a downpayment on a first-time home purchase of a primary residence. It also permits these transactions to be structured either as a loan or an equity investment, a home equity participation agreement.

I would like to pose just one general question of fairness to my colleagues. IRA accountholders are currently permitted to invest in Ginnie Mae mutual funds, which consist of single-family mortgages on other people's homes. However, IRA funds may not be used to finance their own home nor that of a family member. In other words, your IRA can be used to purchase the home of anyone in the country, except for your own home or that of a family member.

This policy is unfair, antihome ownership and antifamily. My proposal would change this. It would do so in a flexible manner but it would also do so in a targeted and careful manner.

The public policy purpose of the bill is to promote entry into the housing market. Therefore, the home buyer must be a first-time home buyer. In addition, the home purchase must be a principal residence. Finally, the loan or equity investment must be repaid upon the sale of the home.

My bill also contains specific provisions to prevent self-dealing or tax gaming. I won't take you through each provision right now. Simply stated, my bill takes a somewhat different approach from most of the penalty waiver provisions, because my bill would also allow the use of the funds without taxation. It does so by changing the prohibited transaction rules to allow the IRA itself to invest in the home mortgage rather than having to withdraw the money from the IRA and pay the tax on it, even though the penalty is waived and then use what is left over.

I believe, Mr. Chairman, that this approach is totally consistent with the proposal in the Contract With America. It does no harm to the concept and I would urge this committee to consider including this general approach in the bill that is marked up. And I would be happy to respond to questions.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF REP. BILL ORTON

before the
House Ways and Means Committee
January 31, 1995

"FIRST-TIME HOMEBUYER AFFORDABILITY ACT OF 1995"

Mister Chairman, members of the Committee, I appreciate the opportunity to testify before you today. The goal of increasing savings and investment is critical to our country's long term economic prospects. I commend you for calling this hearing.

Mr. Chairman, study after study have demonstrated that the most significant barrier to homeownership in this country is the high level of downpayment generally required to secure approval of a mortgage loan.

Yet, because of our current tax laws, the $ 850 billion currently invested in individual retirement accounts (IRA's) are effectively precluded from being used for such downpayment purposes, either directly by a homebuyer or through a parental loan. **I have come before you today to advocate changes to these laws to dynamically open up this $ 850 billion of assets and put them to work to promote homeownership.** It is my hope that this committee will consider addressing this issue when marking up HR 6, the "American Dream Restoration Act."

Yesterday, I re-introduced the "First-time Homebuyer Affordability Act." I have been working on this legislation for over three years. I first introduced this bill back in 1992, in the 102nd Congress. Last year, I re-introduced this legislation, as HR 1149. **HR 1149 was a bi-partisan effort, with 28 co-sponsors, about equally split between Republicans and Democrats, including the distinguished Chairman of the Rules Committee, Gerald Solomon. HR 1149 was formally endorsed last year by both the National Association of Home Builders and the Mortgage Bankers Association of America.** The bill I re-introduced yesterday is virtually identical to HR 1149, with a few minor perfecting changes.

First, let me explain the need for this legislation. Current IRA statutes prohibit an IRA account holder from engaging in a number of "prohibited transactions", including loans to family members and use of one's own IRA funds for personal use. If anyone uses IRA funds for a prohibited transaction, the penalties are severe. The money that is used is subjected to full federal and state income taxes. In addition, a 10 percent premature withdrawal or distribution penalty is assessed on the amount withdrawn. Combined, an IRA account holder may be forced to pay over 50 % of the amount withdrawn in taxes and penalties [see Exhibit B]. The result is that **under current law, individuals are effectively precluded from using IRA funds to make a down payment to buy a home.**

PROVISIONS OF "FIRST-TIME HOMEBUYER AFFORDABILITY ACT OF 1995"

My legislation overcomes this barrier by providing a targeted exemption from prohibited transaction rules to allow individuals to access IRA accounts to make a down payment on a first-time home purchase. By structuring the use of funds as an economic transaction entered into by a self-directed IRA account, the tax and premature withdrawal penalties are avoided -- resulting in a substantial savings to the homebuyer. By eliminating barriers to the use of IRA funds, this change would have a significant impact in increasing homeownership. Finally, this approach is pro-savings. By structuring use of IRA funds as an economic transaction within an IRA, the monies used to buy a home are eventually restored to the IRA, available for continued tax-deferred re-investment.

Specifically, my bill:

(1) **Permits individuals to borrow money <u>from</u> their own IRA account to make all or part of a down payment for a first time home purchase of a primary residence. [This is similar to loans permitted from one's 401(k) account].**

(2) **Permits parents to lend money <u>within</u> an IRA account to their children for use as a down payment on a first-time home purchase of a primary residence, AND**

(3) **Permits the transactions permitted in (1) and (2) above to be structured as an equity investment (ie., a home equity participation agreement).**

Mr. Chairman, I would like to pose a general question of fairness. IRA account holders are currently permitted to invest in a Ginnie Mae mutual fund, which consists of thousands and thousands of single family mortgages -- on other people's homes. However, IRA funds may not be used to pay for or finance your own home, nor for the home of a family member. In other words, **your IRA account can be used for the purchase of any home in the country except your own home or the home of a family member? This policy is unfair, anti-homeownership, and anti-family.**

Moreover, consider the purpose of IRA's. IRA's are intended to promote long-term productive investments to provide a nest egg for retirees. Historical studies have shown that one's home is generally the largest and most important asset people have. It is probably also the best investment they will ever make. Shouldn't IRA funds be available for this important purpose?

Consider, finally, that we do permit individuals to borrow from their 401(k) retirement accounts to purchase a home. A 401(k) plan is nothing more than a self-directed retirement plan -- in much the same way an IRA account is. If we allow people to borrow money from a 401(k) plan for this purpose, shouldn't we also allow borrowing from an IRA account?

I believe we should. My legislation allows this to be done in a flexible, but responsible manner. My bill allows 100 % of the funds in one's IRA account to be used for a first-time home purchase, structured either as a loan or an equity sharing investment.

Under my bill, IRA advances structured as a loan may be flexible. Any loan from an IRA can be for a term of up to 15 years. The loan may be interest only (no principal amortization). And, interest on the loan may be deferred until repayment of the loan. These two options increase flexibility with respect to cash flow. Finally, the loan may be unsecured or may be secured (typically by a second lien on the home). This increases flexibility with respect to second mortgage limitations typically imposed by secondary market mortgage lenders like Fannie Mae and Freddie Mac.

IRA advances structured as an equity sharing agreement are intended to mirror current free market practices, in which homebuyers give up part of the appreciation of value of their home in return for vital down payment assistance. To preserve the concept of having the IRA engage in economic transactions, my bill requires that equity sharing arrangements be structured under terms similar to those made in arm's length transactions.

While flexible, the bill is also structured in a careful, targeted manner. The public policy purpose of the bill is to promote entry into the housing market. Therefore, the home buyer must be a first-time homebuyer. In addition, the home purchase must be a principal residence. Finally, the loan or equity investment must be repaid upon the sale of the home.

My bill also contains provisions to prevent self-dealing or tax-gaming. For example, the interest rate on the loan must be no less than 200 basis points below and not more than 200 basis points above comparable Treasury rates. In this way, the IRA earns at least a fair rate of return, but individuals cannot funnel excessive tax-deferred funds into an account. Perhaps most importantly, my bill provides that forgiveness or default on loan or equity repayment subjects an IRA to premature distribution treatment -- making the funds subject to tax and withdrawal penalty. This effectively prevents individuals or parents from converting IRA funds tax-free to personal use through a fabricated default.

COMPARISON WITH PENALTY WAIVER

Over the last few years, there has been a great deal of support for the "penalty waiver" concept. This approach was included in HR 4210, a major tax bill approved in the 102nd Congress, but vetoed by the President. The penalty waiver provision was also included in the Super-IRA bills introduced last year by Senator Roth in the Senate and Representatives Thomas and Pickle in the House. Many members of both the House and Senate have introduced legislation incorporating this concept.

Quite simply, the penalty waiver approach provides for a waiver of the 10 % penalty on premature IRA withdrawals for certain identified purposes. Typically, qualified purposes in legislative proposals include first-time home purchase, higher education expenses, and emergency medical bills.

Clearly, adoption of this type of proposal would make it easier to access IRA's for these purposes. However, penalty waiver advocates generally fail to emphasize that the IRA account holder would still owe federal and state income taxes. At best, a penalty waiver would marginally reduce the huge negative incentive against using IRA funds to buy a home.

Let me illustrate this point [see Exhibit B]. Take a hypothetical case in which a young couple plans on buying a house, requiring a down payment of $ 10,000. Let's assume the couple's sole source of long-term savings is the $ 10,000 they have in their IRA account. Let's also assume that this couple is in a marginal 28 % federal tax bracket, and a 6 % marginal state tax bracket. As Exhibit B shows, **even under a penalty waiver approach, this couple would still forfeit almost 1/3 of the amount in their IRA account to state and federal taxes. Moreover, they would only have $ 6,768 left to invest -- not enough to make the required down payment. In contrast, under my legislation, the couple could lend themselves all of the $ 10,000 -- with no tax or penalty consequences.**

This difference is especially important when considering parental loans. It is true that certain penalty waiver proposals permit parental withdrawals to assist their children with a down payment. But I think it would be a very rare case in which a parent would be willing to take $ 10,000 from their IRA account, suffering an unnecessary tax of from $ 3,000 to $ 4,000, to assist their children with a down payment.

Thus, a penalty waiver sounds like a good public policy change. However, in practice, it would have only a marginal impact -- reducing one's tax/penalty by only around 20% of the amount otherwise owed. This incentive will induce relatively few people to actually take money out of their account to buy a house, compared to current law. As a result, it will produce a very small increase in the level of homeownership in this country.

Let me turn now to your legislation, Mr. Chairman. As I understand it, the "American Dream Restoration Act" does not provide for a penalty waiver, or other direct incentive to take money directly out of an IRA account to buy a home. However, current IRA account holders would be permitted to roll over their account into a new Dream Savings Account, after which they could withdraw that money, tax and penalty-free, for a first-time home purchase (among other things). The effect is to give current IRA account holders the equivalent of a penalty waiver -- since they will suffer a tax from the rollover, but no tax or penalty from the subsequent withdrawal. Again, I believe this is a commendable change. However, I believe we can and should do more to access IRA accounts for homeownership.

Mr. Chairman, the impact of your "American Dream Restoration Act" is to increase opportunities for IRA investments and to increase flexibility for meritorious purposes, such as a first-time home purchase. I believe my legislation is consistent with and promotes these goals. The "First-time Homebuyer Affordability Act" could easily be added onto your bill. Therefore, I would ask the Ways and Means Committee to consider adding the provisions of my legislation to the American Dream Restoration Act when that bill is marked up.

EXHIBIT A

EXECUTIVE SUMMARY
FIRST-TIME HOMEBUYER AFFORDABILITY ACT OF 1995

Current IRA statutes prohibit an IRA account holder from engaging in a number of "prohibited transactions", including loans to family members and use of one's own IRA funds for personal use. This bill provides a targeted exemption from such prohibitions to access IRA accounts to make a down payment on a first-time home purchase -- without tax or premature withdrawal penalty. This approach could be used either in place of or in conjunction with the so-called "penalty waiver approach. Specifically, the bill:

(1) Permits individuals to borrow money <u>from</u> their IRA account to make all or part of a down payment for a first time home purchase of a primary residence [similar to loans permitted from one's 401(k) account],

(2) Permits parents to lend money <u>within</u> their IRA account to their children for use as a down payment on a first-time home purchase of a primary residence, AND

(3) Also permits the transactions permitted in (1) and (2) above to be structured as an equity investment (ie., a home equity participation arrangement).

UNDER THIS APPROACH, FUNDS WOULD BE FREE OF TAX <u>AND</u> PREMATURE WITHDRAWAL PENALTIES. IN COMPARISON, UNDER THE PENALTY WAIVER APPROACH, INDIVIDUALS WOULD SUFFER TAX CONSEQUENCES OF OVER $ 3,000 ON A $ 10,000 INVESTMENT.

ANOTHER ADVANTAGE IS THAT FUNDS ARE AVAILABLE FOR TAX-DEFERRED REINVESTMENT WHEN THE FUNDS ARE RESTORED TO THE ACCOUNT.

<u>GENERAL PROVISIONS</u>

* Home purchases are limited to first-time homebuyers.
* The home purchased must be a principal residence
* All funds in one's IRA account can be used for a down payment.
* Loan may be either secured or unsecured
* Interest on loan may be deferred; loan may be interest only
* Loan can be for a term of up to 15 years
* The interest paid on any loan and the repayment of a loan or equity investment continues to accumulate within the IRA account on a tax-deferred basis

<u>RESTRICTIONS TO PREVENT SELF-DEALING</u>

* Loan or equity investment must be repaid upon the sale of the home
* Loan interest rate must be no less than 200 basis points below and not more than 200 basis points above comparable Treasury rates
* Forgiveness or default on loan or equity repayment subjects IRA to premature distribution treatment - subject to tax and withdrawal penalty.

EXHIBIT B

USE OF FUNDS COMPARISON --

FIRST-TIME HOMEBUYER AFFORDABILITY ACT of 1995
and
PENALTY WAIVER APPROACH

TYPICAL TAXPAYER

Investment within IRA Account		Penalty Waiver Approach	
IRA Account:	$ 10,000	IRA Account:	$ 10,000
Less tax:	-0-	Less tax:	3,232
	--------		--------
AVAILABLE FUNDS:	**$ 10,000**	**AVAILABLE FUNDS:**	**$ 6,768**

NOTE: **UNDER CURRENT LAW, AVAILABLE FUNDS = $ 5,768**
[Additional effect of 10 % penalty for premature withdrawal]

ASSUMPTIONS:
* Marginal federal tax bracket = 28 %
* Marginal state tax bracket = 6 %
* **EFFECTIVE STATE/FEDERAL TAX = 32.32 %**

(Note: effective rate is lower than sum of both, due to federal tax deductibility of state income taxes)

TOP BRACKET TAXPAYER

Investment Within IRA Account		Penalty Waiver Approach	
IRA Account:	$ 10,000	IRA Account:	$ 10,000
Less tax:	-0-	Less tax:	4,434
	--------		--------
AVAILABLE FUNDS:	**$ 10,000**	**AVAILABLE FUNDS:**	**$ 5,566**

NOTE: **UNDER CURRENT LAW, AVAILABLE FUNDS = $ 4,566**
[Additional effect of 10 % penalty for premature withdrawal]

ASSUMPTIONS:
* Marginal federal tax bracket = 38.5 %
* Marginal State tax bracket = 9.5 %
* **EFFECTIVE STATE/FEDERAL TAX = 44.3425 %**

(Note: effective rate is lower than sum of both, due to federal tax deductibility of state income taxes)

EXHIBIT C

QUALITATIVE COMPARISON OF

FIRST-TIME HOMEBUYER AFFORDABILITY ACT of 1995
with
PENALTY WAIVER APPROACH

1. **SHORT TERM TAX SAVINGS TO INDIVIDUAL.**

The First-time Homebuyer Affordability Act has two major short term advantages over a penalty waiver: (a) the individual avoids imposition of taxes and (b) more funds are available for down payment on a home purchase. [see Exhibit B for comparison].

2. **PROMOTION OF HOME OWNERSHIP/ECONOMIC GROWTH**

Because of the advantage in 1 above, it will result in significantly greater use of IRA funds for home purchase. This will stimulate higher levels of homeownership. Resulting increased housing starts should also stimulate economic growth.

3. **LONG TERM TAX SAVINGS TO INDIVIDUAL**

Under the penalty waiver approach, there is a permanent withdrawal of funds from the IRA account. As a result, the compounded tax deferral of principal and interest is lost. In contrast, since all IRA funds are retained under the First-time Homebuyer Affordability act, interest/earnings continue to be tax deferred during the period they are invested in the home AND are tax deferred in the period after the home investment ends.

4. **PREVENTION OF LEAKAGE FROM RETIREMENT FUNDS.**

Economists have made a strong connection between our low rate of national savings and our failure to make productivity gains. Adequate national savings is critical as a source of capital for modernization so that American companies can compete internationally. The "First-time Homebuyer Affordability Act" promotes the goal of increased individual savings, by permitting first time home investments within IRA accounts, thus avoiding leakage from retirement and savings accounts. In contrast, a penalty waiver approach tends to encourage funds to flow out of savings accounts.

Chairman ARCHER. Thank you.

Congressman Baker, we are delighted to have you here with us today, and we will be pleased to hear your testimony.

You may proceed.

STATEMENT OF HON. BILL BAKER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. BAKER. Thank you very much, Chairman Archer, and it is an honor to be here.

I want to thank you for allowing me to come before the committee to discuss the critical issue of IRA reform and the national savings rate as it relates to the Contract With America. I have prepared a written statement to supplement my testimony, and with your permission, request that it be inserted in the appropriate point in the record.

Americans save but a fraction of what other people in other nations save. Our savings rate in America is an anemic 4 percent. Taxpayers don't recognize how their lack of savings harms overall productivity and how it relates to interest rates.

The American taxpayer's aversion to saving money is partially due to our erratic and punitive tax policies. It is very difficult to tell someone who is struggling to raise a family and who is being taxed between 40 and 46 percent of their income, to go out and accrue another $2,000 to $5,000 and put it away for their retirements, especially without any tax deduction.

Before 1986—and this is important—19.5 percent of individuals filing tax returns claimed IRA deductions. So prior to the disastrous 1986 Tax Act, almost 20 percent of the people were saving for their retirement; 16 million people saved in those days $13 billion. So these horrendous figures you hear, if you go back to an IRA you are going to bankrupt the Nation and keep the budget from being balanced, in 1986, 16 million were saving $13 billion, an average deduction of just over $2,000. In 1993, an equal number of returns filed, only 5 percent of taxpayers claimed deductions.

So what happened is people when they didn't get the carrot of deductibility, forgot about preparing for their retirement years, so only 4.1 million people saved a total of $7.9 billion. So without that incentive of tax deductibility, we have told people, don't prepare for your future, just go to the Social Security window.

The Federal Government should encourage greater savings. In a Merrill Lynch survey recently conducted, married people earning $50,000 a year need to accumulate $170,000 by the time they reach 65 to maintain their current standard of living, even with pension and Social Security benefits. The average baby boomer couple will save only 40 percent of that during their lifetime because they have no incentive to save.

IRA reform is needed now and to be effective it must bring more people into the pool. It has to be more flexible, as Mr. Orton just mentioned, and it cannot sacrifice the purpose, retirement savings, for other duties, such as the social welfare aspects of the current Social Security program.

Mr. Chairman, my IRA reform, the Family Reinvestment Act, meets these criteria. It replaces the inadequate $2,000 deduction with $2,500 each spouse, regardless of whether they work. It is cruel for the nonworking spouse to raise a family and come then to the end of the line and have no retirement benefits. Even more cruel if a divorce occurs during that time and the person who has spent their time at home is left without adequate retirement.

It extends eligibility to a nonemployed spouse. We phase in this bill over a 10-year period, and I wouldn't care if it was over 100 years, as long as the road of 1,000 miles begins with the first step. This allows investors to borrow from their plans for only three purposes: One, first-time home buyer; and for college; and for medical and retirement benefits, for the person himself or herself, before retirement.

It maintains the focus of IRA on retirement. I want to emphasize the word "borrow." If you have a son or granddaughter that needs to go to college, you can take from your IRA and loan them that money. But they must repay it—fat chance.

You will probably during your working life repay it so that at the end of the line, you would have your retirement plan intact. So the borrow facility is important.

The nonworking spouse part of this bill is important. And raising over a number of years the amount saved each year to $5,000 per couple is extremely important, if we don't want to depend totally on government-financed retirement accounts.

I would like to close with this warning. The optimists tell us that if we go through the baby boomers receiving money from Social Security and they collect for 20 years before we bankrupt Social Security, we will go to the year 2030. If the pessimists are correct and we bankrupt it in the first few years of the baby boomers coming to the window, then we will bankrupt Social Security by 2013. It has nothing to do with politics, has nothing to do with Republicans, Democrats, Contract With America; just there are too many people asking for too great a retirement amount, considering the number of people still working, and you will run out of money. That is a fact.

What is the answer; to bemoan that, to change Social Security, to get into a long war in which we go to the ballot box and tell somebody they hate the elderly more than I love the elderly? That is not the answer. The answer is to wean people today, get them on their own retirement plans, and IRA is the way to do it. If, to answer Mr. McDermott's question, this means postponing balancing the budget for 1 more year to take care of the $13 billion that people will save if they get the deductibility so be it, because you have corrected a problem that will reach us in the middle of the 21st century and hit us very hard.

I appreciate the time to speak and will answer any questions that you might have.

[The prepared statement follows:]

TESTIMONY OF THE HONORABLE BILL BAKER BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

IRA REFORM IN THE CONTRACT WITH AMERICA AND THE FAMILY REINVESTMENT ACT

January 31, 1995

Mr. Chairman, I appreciate having the opportunity to speak here today on an issue of national economic importance. The health of our economy is obviously dependent upon many factors, most of which you will consider in this committee. And now, as we consider the various reforms contained in the Contract with America in Congress, we have an opportunity to address one such economic concern in the near future -- our national saving rate. So today, Mr. Chairman, I am here to talk about my bill to reform Individual Retirement Accounts, the Family Reinvestment Act, which I will soon reintroduce.

That Americans save but a fraction of what people in many other nations do is well known. The current estimate of the rate of saving in the U.S. is an anemic four percent. Most Americans, however, are less aware not only of the magnitude of the problem, but of its very existence. The fact is, in order to maintain even modest economic growth, we must either bring money into the economy through foreign investment, or increase our own saving rate.

What most Americans know about the savings crisis is limited to what they see reflected in their own lives. Many find themselves increasingly unable to meet their own needs. But what they see less is how their inability or unwillingness to save harms overall productivity. Few notice the drop in the availability of investment capital. But many people do know of American industry's increasing reliance on foreign capital to fund operations and fuel the economy, and they recognize it as a disturbing trend. The connection must be made between personal savings and our addiction to foreign capital in order to maintain economic growth if people are to clearly recognize their role in this tenuous situation.

A study released last year by the National Center for Policy Analysis demonstrates that the household saving rate has a greater impact on foreign capital imports than does the federal budget deficit (as is commonly blamed). According to the study, the $55.3 billion decline in personal savings between 1992 and 1993 exceeded the $42.8 billion decline in the budget deficit at the same time. Meanwhile, foreign capital imports increased because less savings were available for investment. Government borrowing, it seems, is less a factor than personal savings.

So why don't Americans save more? Though no one reason can be given, certainly our government's erratic and punitive tax policies have had a forceful impact. Our tax code rewards consumption and discourages saving. When the average wage earner learns that accumulating interest only raises his taxes, the benefits of consumption seem greater than the benefits of saving. Some sort of tax neutrality is needed if Americans are to be convinced to put more money away for their future needs. And they must be convinced. Getting our saving rate up to around eight percent would add over $180 billion annually to the national supply of savings, and virtually eliminate the need for foreign capital.

Because the federal government has a role in reducing interest costs and increasing jobs and production, it can and should play a significant role in encouraging greater savings. As fewer and fewer young workers finance the retirement of more and more retirees, recent polls reveal that young Americans no longer believe government-run Social Security will be sufficient to sustain them in later years (indeed, it was never intended to). And a survey done by Merrill Lynch indicates that the average married couple making $50,000 per year would need to accumulate at least $170,000 in savings by age 65 to maintain its standard of living, even with a pension and Social Security. Yet these same individuals are penalized through the tax code from saving more on their own. The average baby boomer couple is likely to save only 40 percent of what it will need to retire. It is for these reasons that expanding the availability and scope of Individual Retirement Accounts is a timely public policy consideration.

For true reform of the current IRA to be effective, it must make IRAs more attractive and thereby bring more taxpayers into the investment pool. It must also make IRAs more flexible to be used as individuals' needs arise. But flexibility must not sacrifice the true purpose of the IRA -- retirement savings.

Mr. Chairman, my IRA reform bill, the Family Reinvestment Act, meets these criteria.

First, my bill seeks to bring new investors into the IRA system. It scraps the wholly inadequate $2,000 deduction level, replacing it with a $2,500 yearly deduction. It also expands eligibility to include non-employed spouses, a group which is unfairly excluded under current IRA rules. And my bill "phases in" higher-income taxpayers as it increases the current income phaseout levels over a five year period. The levels are raised from $25,000 to $100,000 for individuals and from $40,000 to $200,000 for couples. All of the levels in my bill are indexed to inflation after the phase-in period is complete.

Next, my bill seeks to make IRAs at least as flexible for the average American as the popular Thrift Savings Plan, or TSP, is for government employees. The TSP is a benefit that many workers take advantage of here on Capitol Hill. Though my purpose here is not to sing the praises of the TSP, I should explain that involvement in the plan allows investors to borrow at the current rate from their plans. The key is that this money is a qualified distribution which must be repaid. It is time for all American families to be offered this kind of flexibility.

My bill allows qualified distributions for first-time home buyer expenses on a principal residence for the IRA holder, his spouse, his child, or his grandchild. This includes acquisition costs, construction or reconstruction, and financing and closing costs. This loan must be repaid with interest within 15 years of the distribution to avoid being taxed.

Similarly, qualified distributions for higher education expenses are allowed, including for such items as tuition, fees, books, supplies and enrollment and attendance costs. This loan must be repaid with interest within ten years. My bill also treats numerous qualified distributions received in the same taxable year as one, so individuals may borrow from their accounts as money is needed.

Finally, my bill maintains the focus of the IRA option on its principal purpose -- increasing savings. The repayment requirement is meant to assure that these accounts are not used only as tax-free pools for home-buying or education expenses, but remain the retirement investment tool they were originally intended. Loans outstanding at the end of the repayment period are treated as "unqualified" distributions and taxed as income, plus the current ten percent penalty, plus interest. Distributions from the IRA also may not drop the total balance below $1,000. Together, these rules will help to ensure that taxpayers continue to plan for their retirement, even as they confront important financial hurdles along the way.

Mr. Chairman, I don't think we, as fiscal conservatives, will disagree that these are important measures to address. But what concerns me is that the proposed IRA changes in the Contract with America do not go far enough in accomplishing our stated goals.

The American Dream Savings, or ADS, account outlined in the Contract in H.R. 6, the American Dream Restoration Act, is commendable in its goal, yet I believe it comes up short in the areas my bill addresses. First, the ADS account, as a "back-ended" IRA, effectively repeals the current IRA deduction, a significant incentive for lower- to middle-income wage earners. My bill actually increases this deduction in order to make saving for retirement a more attractive option. Despite the unique nature of a "back-ended" IRA, I do not believe the ADS offers sufficient incentives to bring additional taxpayers into the IRA system. And although the rules of the ADS do not include special purpose qualified distributions as gross income, I believe the most important goal of the savings tool is compromised in that **there is no repayment requirement**. This is essential to any IRA reform.

The debate over the Contract, Mr. Chairman, is really about empowering people to provide for themselves. The federal government should seize its role as the facilitator of greater personal freedom and opportunity. I believe very strongly in the stated goals of the Contract. They are, to a substantial degree, why I am in Congress. But as it stands right now, I believe the provisions related to IRA reform can be improved.

Thank you, Mr. Chairman, for letting me come here today to express my opinions on IRA reform. I am sure this committee has and will continue to consider very seriously issues like IRA reform, which affect the well-being of families, individuals, and the economy. I call upon you, Mr. Chairman, to lead your colleagues in this committee in examining all opportunities for increasing savings in America. I firmly believe that as you do, you will discover that my Family Reinvestment Act clearly corresponds with the other monumental changes we are all striving to make to enhance the lives of Americans in the future.

Thank you very much for your time.

# # #

Mr. THOMAS [presiding]. I thank the both of you for your testimony. It is interesting how economics gets in the way of politics. We appreciate your indication that there is an inevitable facing us, regardless of what the political position is that we take. Any member on the majority side wish to inquire?

Does the gentleman from Washington or the gentleman from Michigan wish to inquire.

We thank both of you very much for your testimony.

Mr. THOMAS. I would ask that the next panel come forward, John L. Steffens, chairman of the board of Securities Industry Association, Kenneth Feltman, executive director, Employers Council on Flexible Compensation; William Gale, senior fellow, Brookings Institution; Mary Mohr, chairperson, Savings Coalition of America; John Brennan, president, The Vanguard Group; and Charles Hazen, Southampton, Pa.

Any written statements will be made a part of the record, and you have 5 minutes to proceed. If you will allow me, I will start with Mr. Steffens.

STATEMENT OF JOHN L. STEFFENS, CHAIRMAN OF THE BOARD, SECURITIES INDUSTRY ASSOCIATION, AND EXECUTIVE VICE PRESIDENT, MERRILL LYNCH AND CO., WASHINGTON, D.C.

Mr. STEFFENS. I am John Steffens, the chairman of the Securities Industry Association and executive vice president of Merrill Lynch. The SIA is the securities industry's trade association, representing 800 securities firms in North America which account for about 90 percent of all securities activity in the United States. These firms have had extensive experience with IRAs in the past and overall, our industry manages about $585 billion of clients' IRA assets.

Thank you for focusing your attention on what I think is a vital issue, the Nation's savings crisis. This issue is vital to our economic future.

The name of the saving vehicle you are considering today, the American dream savings account, is right on the mark. The SIA believes that savings crisis has truly put the future of the American dream at risk. Whether the American dream is defined as financial security, a home, an education, a good job or comfortable retirement, low savings is going to make that more difficult to achieve.

Congress has an opportunity and a responsibility to change this; to help solve the savings crisis that exists today; and most importantly, to put Washington back on the side of the American dream by expanding IRAs. IRAs are a proven and powerful tool to boost savings. The SIA believes the facts are fairly simple. IRAs worked before from 1982 to 1986. And the newly proposed IRAs will work even better.

The SIA's full position is outlined in the written testimony. Let me summarize six reasons why IRAs are the right economic policy for America, the right tax cut for the middle class, and the right savings vehicle for American families.

First, it is clear that the American people themselves want to bring the IRA out of retirement. A postelection survey done by The Luntz Research Companies showed that the IRA was the most popular tax proposal included in the Contract With America. This shouldn't be surprising since other research has shown that concerns about savings and retirement rank higher than almost every other political issue.

Second, there is a growing consensus among academics that IRAs work. SIA recently asked two leading economists, Jonathan Skinner and Glenn Hubbard to sort through the scores of IRA studies that had been done over the last several years. After reviewing this body of scholarly work, these professors concluded that there is compelling evidence that IRAs did, in fact, boost personal and national saving. They noted that even some past IRA critics now acknowledge IRAs work.

Third, IRA critics overstate the significance of any shuffling of assets into IRAs. A quick look at the facts shows why. In 1983, half the American families had less than $1,000 in net financial assets. Even families headed by people 45 to 54 years old had median net financial assets of only $2,600. The bottom line is these people simply don't have enough assets to shift savings from other vehicles to IRAs for long.

Fourth, middle-class Americans will be the biggest winners from the new IRA. The committee should recognize that IRAs were overwhelmingly used by middle-income Americans from 1982 to 1986. Over 75 percent of IRA contributions were made by families with incomes of less than $50,000.

Fifth, the new IRAs will foster a culture of savings in the United States. A new IRA program is going to encourage financial firms to spend tens of millions of dollars advertising the savings benefit, and I think this will help educate Americans on the need for long-term savings. This will send a very important signal to Americans that it is time to become a nation of savers again.

Finally, while IRAs worked before, the features of the new IRAs will help them work even better. New proposals like the American dream savings account, the Thomas-Neal super IRA, the President's IRA, and certainly the homemaker IRA, which creates equal treatment for spouses who work in the home, all of these include withdrawal features that will make the IRA even more popular and effective.

The other key feature of the proposed IRAs is the back-end tax incentive. At Merrill Lynch, we have conducted extensive market research on back-end savings accounts and we are convinced that they hold great appeal to the American public. In fact, we forecast that roughly one-half of Americans, if given a choice and clear explanation of the benefit, would opt for a back-end IRA.

Ideally, the SIA would like to see IRAs with both front-end and back-end account options. Then Americans could decide for themselves which type of an account would be better given their personal view of the future. But even if the new legislation includes just the back-end option, as the American dream savings account does, SIA still believes that it would boost savings in the United States dramatically.

Let me close by mentioning that most Americans feel today that government discourages them from saving. You can change this by bringing back the IRA. Contributions to a new and popular IRA could accumulate to more than $1 trillion over the first 10 years of this program. This would not only provide a huge pool of capital to help the U.S. economy grow, but would also create a $1 trillion nest egg for American families in the future.

Finally, as IRAs boost savings, they will also pay fiscal dividends for the Federal Government. The econometric model used by Merrill Lynch suggests that the successful implementation of IRAs could reduce U.S. interest rates by 50 basis points over the coming years. This would mean a savings of some $25 billion a year to the U.S. Government in terms of reduced interest payments on government debt and would help every American in terms of reduced interest costs on mortgages and other loans.

In short, a revitalized IRA would not only work, we at SIA believe that an expanded IRA would be a first and very important step toward saving the American dream.

Thank you very much.

[The prepared statement and attachments follow:]

TESTIMONY OF JOHN L. STEFFENS
SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the Committee, I am John L. Steffens, chairman of the Securities Industry Association (SIA) and Executive Vice President, Merrill Lynch and Co., Inc. SIA commends you, Mr. Chairman, and the Ways and Means Committee for focusing attention today on America's "saving crisis." We appreciate the opportunity to share our views with you.

The membership of SIA accounts for more than 90% of securities activities in North America. Its roughly 800 member firms range from large firms engaged in a full spectrum of domestic and international securities and securities-related activities to small or local firms engaged exclusively in retail brokerage. The securities industry manages over $585 billion of client Individual Retirement Account (IRA) assets -- about 64% of all IRA assets.

SIA has long been convinced that the United States is not saving enough to remain globally competitive as a nation or financially secure as individuals. The membership of our association believes it is vital that we begin to address this crisis by expanding and modernizing IRAs.

The name of the new saving incentive you are considering today -- the "American Dream Savings Account" -- is particularly apt. In many ways, the U.S. saving crisis has put the future of the American Dream at risk. Whether the Dream is defined as financial security, a home, an education, a good job, or a comfortable retirement, the continued lack of adequate saving makes the American Dream more difficult to achieve.

SIA believes that an expanded IRA will help solve the saving crisis and go a long way toward saving the American Dream. My statement this morning will outline the scope of the saving shortfall in the U.S., address the need for expanded IRAs, and then discuss some specific features of the American Dream Savings Account (ADS Account) and other IRA proposals.

The U.S. Saving Crisis

The United States faces a saving crisis. Americans today are saving less than at almost any time since World War II. The personal saving rate has plummeted from 8 percent of disposable income in 1970 to only about 4 percent in 1994 (see Figure 1). In fact, American households currently save less than *half* as much as those in Britain and Germany and less than a *third* as much as those in Japan and France (see Figure 2).

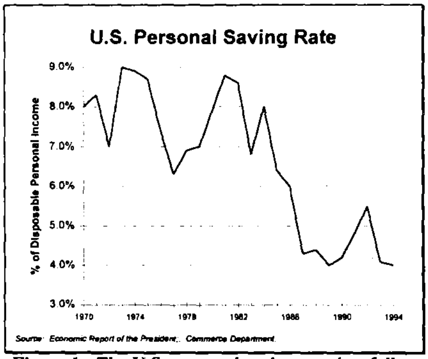

Figure 1: The U.S. personal saving rate has fallen 50% since 1970.

This drop in personal saving has driven the decline in U.S. national saving (which is defined as the sum of all saving by households, businesses, and government) -- a fact some have failed to recognize. There is a persistent myth in Washington that the fall in national saving is attributable largely -- or even entirely -- to rising Federal budget deficits. To the contrary, a close look at the U.S. saving statistics reveals that the fall in personal saving has been a larger contributor to the drop in national saving over the last 25 years than has the increase in the budget deficit. Net national saving has

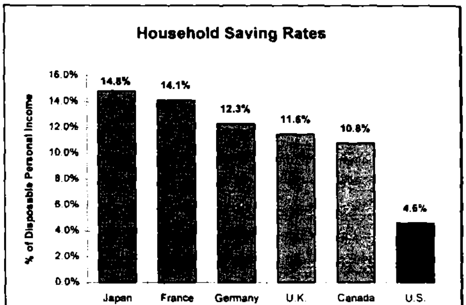

Figure 2: U.S. households save far less than those of our international competitors.

fallen from an average of 8.5 percent of NNP during the 1970s, to 4.7 percent during the 1980s, and to only 2.4 percent so far during the 1990s.

The overall economy and individual Americans alike are being seriously hurt by this historic fall in saving. At the national level, the saving crisis saps the fuel for long-term economic growth, because domestic saving is a vital source of the capital for domestic investment. In today's economy, the fall in personal saving from 8 percent to 4 percent represents a loss of roughly $200 billion of capital that could have been put to work in the U.S. economy. The cost of losing this capital is evident in the steady declines of U.S. domestic investment. While domestic investment averaged about 8 percent of NNP in the 1950s, 1960s, and 1970s, it fell to 6.1 percent in the 1980s and has fallen to just 3.1 percent so far in the 1990s.

As members of this committee know well, the macroeconomic result of low investment is straightforward: Fewer jobs at lower wages. By limiting investment in the American economy, the saving crisis slows business growth and hinders the advance of U.S. living standards.

However, and I want to stress this point this morning, the impact of the saving crisis is *personal* as well as national. As SIA member firms witness every day in our dealings with clients across the U.S., low saving has direct and serious implications for individual families.

This point is illustrated by an analysis of American household finances recently commissioned by my firm, Merrill Lynch. The study shows that *half of all American families in 1993 had less than $1,000 in net financial assets*[1] (see Figure 3). Although older households naturally had greater wealth than younger ones, the study found that even families headed by individuals ages 45 to 54 had only $2,600 in median net financial assets

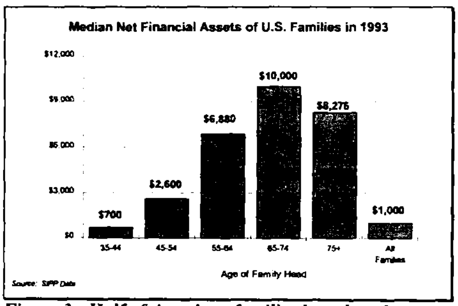

Figure 3: Half of American families have less than $1,000 in net financial assets.

Mr. Chairman, one of the themes of today's hearing is the future of the American Dream. With these figures in mind, is it any wonder the American Dream is a fading vision for many families? They simply don't have a cushion of saving to fall back on in hard times -- let alone the resources to buy a first home, fund a child's college education, or provide for a secure retirement.

On a similarly personal note, other academic research has shown that the future of retirement looks especially bleak for the 76 million members of the Baby Boom generation. Stanford University economist B. Douglas Bernheim's research on the Merrill Lynch Baby Boom Retirement Index^{SM} reveals that Baby Boomers, on average, are now saving at only about one-third the rate needed for a secure retirement.

Dr. Bernheim arrives at this result by comparing the rate Baby Boomers are actually saving for retirement with the rate at which they should be saving in order to retire at age 65 with the same standard of living they enjoyed during their pre-retirement years. An Index of 100 percent would mean that Baby Boomers are saving at just the rate needed to retire at a consistent standard of living. Yet, Dr. Bernheim's most recent calculations -- which are based on data from a national survey of more than 2,000 Baby Boomers -- place the Index at only 35.9 percent, roughly one-third the minimum rate of saving.[2]

In light of work by the Bipartisan Commission on Entitlement and Tax Reform (i.e., the Kerrey Commission) -- as well as a range of academic research -- this calculation may even be based on *over-optimistic* assumptions. Specifically, Dr. Bernheim's "standard" analysis assumes that the future holds no systematic increase in taxes or decrease in the retirement benefits currently promised to Baby Boomers. These are difficult assumptions to justify in light of the Kerrey Commission's conclusion that the Federal government is on an unsustainable fiscal path, which will require extensive changes to current programs, including Social Security.

Sadly, all of this means that the Baby Boomers' financial preparedness is probably far worse than indicated by the "standard" Baby Boom Index results. In fact, when Dr. Bernheim recalculated the Index under an assumption of even moderate future Social Security cuts, he found that it fell from 35.9 percent to just 18.2 percent, suggesting that Baby Boomers should be saving more than five times -- rather than three times -- what they save currently.

Solving the Saving Crisis

Mr. Chairman, SIA believes that America's economic future hinges in large part on solving the saving crisis. Increased saving is vital both to prepare the overall economy for strong growth into the next century and to provide American households with greater financial security today and into retirement.

Fortunately, economic policy makers have a powerful tool to revive the nation's "saving habit." You can expand and modernize IRAs. SIA has been pleased to see the broad, bi-partisan support for an expanded IRA in Congress as well as such strong support for new IRAs from the President and his Administration.

Let me point out that the restriction of IRAs has played an important role in the decline of U.S. saving. Indeed, the drop in annual IRA saving is equal to about 40 percent of the decline in annual personal saving since 1986. Annual IRA contributions peaked in 1985, at just over $38 billion (or, expressed in 1993 dollars, $50 billion). They have fallen every year since, reaching a level of just $8 billion in 1993[3] (see Figure 4). If the IRA hadn't been curtailed by the Tax Reform Act of 1986, we conservatively estimate that the total pool of IRA assets possessed by American families would be $400 billion larger than it is today.

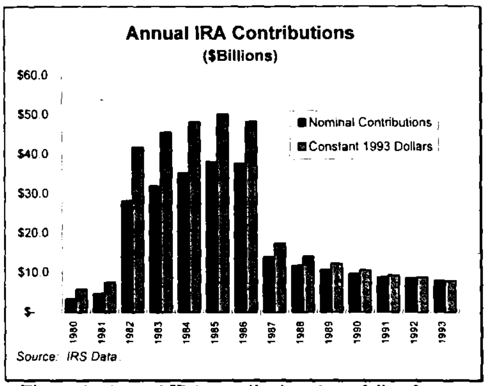

Figure 4: Annual IRA contributions have fallen from $38 billion in 1986 to just $8 billion in 1993.

SIA believes that a revitalized IRA will be popular with the American people, will lift personal and national saving, and will provide an important middle-class tax cut. The balance of my statement will address generally the case for expanded IRAs and specifically the features of the American Dream Saving Account this Committee is considering today.

The first point I would like to make is that the American people clearly want to bring the IRA out of "retirement." IRAs enjoy *exceptional* public support. In fact, a post-election survey by The Luntz Research Companies showed that IRAs were the single most popular tax proposal included in the Republican "Contract With America."

This shouldn't be a surprise. Other recent public opinion surveys have revealed that concerns about saving and retirement rank as high -- or higher -- than nearly every political issue on the table, including health care. In an August 1993 survey of 1,200 Baby Boomers commissioned by Merrill Lynch, 88 percent of respondents said losing their health insurance was one of their fears, while an even greater number, 91 percent, said they feared "Not having enough money to retire on."

Mr. Chairman, it is vital for this Committee to recognize one other reality: Right now the American people reject the idea that Washington is helping them save for the future. Fully 70 percent of Baby Boomers *disagree* with the statement, "The government encourages me to save."[4]

Second, there is a growing consensus among the academic community that IRAs successfully increase both personal and national saving. The list of top academics who have found that IRAs "work" includes Martin Feldstein (Harvard), David Wise (Harvard), James Poterba (MIT), Steven Venti (Dartmouth), Richard Thaler (Cornell), and former-Harvard economist Lawrence Summers, now Treasury Undersecretary for International Affairs.

Since the period of widespread IRA eligibility -- from 1982 to 1986 -- there has been an outpouring of academic research into the effectiveness of IRAs. SIA recently asked respected economists Jonathan Skinner (University of Virginia) and R. Glenn Hubbard (Columbia Business School) to sift through this research and attempt to draw some conclusions from the bulk of the scholarly work. In their new paper, "The Effectiveness of Saving Incentives: A Review of the Evidence," Professors Hubbard and Skinner conclude there is "compelling" evidence that IRAs increase both personal and national saving and recommend that expanded IRAs and 401(k)s be included in any comprehensive strategy to boost U.S. saving.[5]

In fact, Professors Hubbard and Skinner point out that even new research by Eric Engen (UCLA), William Gale (Brookings), and John Karl Scholz (University of Wisconsin) -- who have been critical of IRAs -- suggests that expanded IRAs would indeed boost saving. Computer simulations by Professors Engen, Gale, and Scholz show that, over the long run, increasing the limit on IRA contributions would boost net national saving by $4 for every $1 in tax revenue lost by the government. In their new paper, Professors Hubbard and Skinner characterize this finding as revealing a "powerful bang for the buck" from IRAs.[6]

Third, SIA believes that the significance of any "shuffling" of existing assets into IRAs has been vastly overstated by critics of the IRA program. We reach this conclusion for three reasons. First, consider the financial wealth actually possessed by typical American households. As mentioned earlier, half of all U.S. families in 1993 had less than $1,000 in net financial assets. The fact is, most Americans -- even if they were willing to lock their existing saving up in relatively illiquid accounts -- simply don't have very much in the way of financial assets to "shuffle" over to an IRA. The overwhelming share of households would run out of money to shift into the ADS Accounts or other IRAs in just a few years.

Second, a number of empirical studies of IRA saving suggest that the extent of "shuffled" saving is actually quite limited. For example, in a 1991 paper Professors Wise and Venti estimate that fully 66 percent of an increase in IRA contributions comes at the expense of current consumption; 31 percent comes from the tax subsidy; and only 3 percent comes from a "re-shuffling" of existing saving.[7] Professors Wise and Venti conclude, "Most of the new IRA saving resulting from an increase in the [IRA contribution] limit would represent a net increase in total saving; there would be little substitution away from other saving."

Cornell economist Richard Thaler has offered a third important insight concerning the "shuffling" critique of IRAs.[8] Dr. Thaler has argued that IRAs increase saving *regardless* of whether the money put into them was "shuffled" from another saving account. Why? Because people are much less likely to spend IRA saving over the long run than money in a regular checking or saving account. As Dr. Thaler writes, "Money in a saving account can be splurged on a new car, but money in an IRA is likely to stay put." This is a simple point, but one often missed by those who criticize IRAs on the grounds they are funded with "shuffled saving." Because IRAs get money into an account targeted for specific needs -- where it won't be quickly spent -- they will increase long-term saving even if the funds put into them would have been saved anyway in a regular account.

Taken together, SIA believes these three arguments demonstrate that there is much less to the "shuffled saving" critique of IRAs than meets the eye.

Fourth, all the evidence shows that middle-class Americans will be the big winners from an expanded IRA. From 1982 to 1986, IRAs were overwhelmingly used by middle-income Americans. At the peak of the IRA program in 1985 and 1986, 75 percent of IRA contributions were made by families with annual incomes under $50,000.[9] In fact, the contribution limit on the ADS Accounts and other IRAs ensures their "progressivity" -- the relative benefits of funding these saving vehicles will always be greater for families with lower incomes.

Unfortunately, the IRA income limits established in 1986 were *not* indexed for inflation. This is why IRA eligibility continues to decline sharply. Among workers whose spouses also work, 53 percent were eligible for a full IRA deduction in 1987. This fell to 45 percent eligible in 1991 and only 38 percent eligible in 1995.[10]

Treasury Undersecretary Summers has highlighted one direct impact of dwindling IRA eligibility: *dwindling IRA advertising.* Dr. Summers argues that IRA advertising played a key role in improving attitudes toward saving and that, without this advertising, America has lost a powerful reminder of the need to save. In his words:

> *"Given our national saving problem, it is unfortunate that polls reveal that many people regard increased saving as bad for the economy because it reduces demand for goods. IRAs and the advertising they generate are a useful counterbalance to this sentiment. The existence of IRAs may cause people to focus more on the need to save for their retirement than they otherwise would. IRAs certainly give banks and other financial institutions a strong incentive to remind people of the need to save for retirement. Unfortunately, since the partial repeal of IRAs in 1986, this incentive has dwindled."*[11]

Dr. Summers's observations bring me to my fifth point: Beyond their direct benefit as a saving vehicle, expanded IRAs will play an even larger role in solving the saving crisis. They will help shift American culture. A restored IRA will encourage banks and other financial service providers nationwide to spend tens of millions of dollars advertising "saving." As with the IRA program from 1982 to 1986, this advertising will be diverse and prolific. It will no doubt succeed in getting many clients who formerly contributed annually to IRAs back into the "saving habit." This advertising will also lead millions of new savers to open IRA accounts.

Mr. Chairman, SIA hopes that this Committee understands just how significant such a change in advertising message could be. It should be viewed as an integral part of a "national saving campaign." Anyone who doubts this has only to compare the experience of walking down a city street in Canada -- where the windows of financial service firms advertise the opportunity to save in that nation's tax-preferred accounts -- with the experience of walking down a similar street in the U.S. -- where window advertising by financial firms often promotes more and better ways to *borrow*. The difference is striking and, I believe, goes a long way toward explaining why the household saving rate in Canada is more than twice the household saving rate in the U.S.

By restoring the IRA, the 104th Congress can literally change the advertising message reaching the passer-by on countless streets across America. The promotional efforts surrounding an expanded IRA would send a powerful message, day-in and day-out, to U.S. consumers: *"It's time to become a nation of savers."*

Sixth and finally, while IRAs worked before, the newly proposed IRAs will work even better. The IRAs of the 1970s and 1980s were designed only for retirement saving. Yet, as the ADS Account, the Thomas-Neal "Super IRA" and the President's IRA proposal all recognize, retirement is just *one* of the components of the American Dream. Education costs, a home, or medical expenses may be even more pressing needs for today's families.

The expanded withdrawal features of the ADS Account will make it an even more popular -- and effective -- saving incentive than the traditional IRA. At Merrill Lynch, our research has shown that people who begin to save for any reason begin to save more in other forms. In other words, putting some money away for the future, regardless of the objective, fosters a broader, healthy "saving habit." Based on our experience, we believe the ADS Account's withdrawal features will encourage new saving among Americans who may still be years away from seriously focusing on retirement. And once these people begin to save -- whether it is for a home or for education costs -- they will keep at it, consistently adding to their ADS Account balances.

The experience in Canada over recent years backs this point up. The Canadian Registered Retirement Saving Plans (RRSP) which now exist provide for unlimited, penalty free withdrawals before retirement. An important new study by Professors Wise and Venti shows that these plans have been extremely successful in stimulating new saving.[12]

Another key element of the ADS Account -- as well as the Thomas-Neal "Super IRA" and the President's IRA proposal -- is the "back-end" tax incentive. This feature would allow Americans to make deposits to the account from *after-tax* dollars, while qualified withdrawals would be tax free. Although "back-end" saving incentives and traditional, "front-end" saving incentives are economically equivalent, the existence of the "back-end" incentive can offer important new flexibility for American savers.

There is some controversy among the academic community over whether "back-end" saving vehicles would be as popular and effective as "front-end" IRAs were during the early 1980s. Mr. Chairman, this Committee should realize that, since a "back-end" saving incentive has not existed in the U.S., academic economists lack any empirical evidence on which to draw conclusions.

At Merrill Lynch, we have conducted extensive market research on "back-end" tax incentives over the past five years. This research has included a series of in-depth, national public opinion polls as well as qualitative, focus-group discussion sessions. Based on this evidence, we are convinced that a "back-end" saving incentive will be extremely popular with, and widely use by, the American people. Merrill Lynch's early forecasts show that about half of Americans, if given the choice, would opt for a "back-end" saving incentive.

Ideally, SIA would like to see Congress give Americans a choice between a "front-end" and "back-end" saving incentive by including both of these options in any new IRA legislation. This would provide individuals with the flexibility to select the saving incentive that best matches their personal view of the future.

Nevertheless, if new IRA legislation passed by the Congress includes only a "back-end" saving incentive -- as the ADS Account does -- SIA still believes it will be a successful vehicle to boost personal and national saving in the U.S.

Saving the American Dream

A revitalized IRA would create a vast pool of new savings in the American economy. Merrill Lynch's early estimates suggest that contributions to a new and popular IRA could accumulate to more than $1 trillion within the first ten years of the program. These funds would represent not only $1 trillion of capital for new investment by U.S. businesses, but also a $1 trillion nest egg for the benefit of American families.

Even the Federal budget would be helped by greater saving. I personally believe it is realistic to project that a new IRA program could add $40 billion annually to net national saving. Based on the econometric model we use at Merrill Lynch, this additional saving would lead over the long run to a 50 basis point drop in U.S. interest rates. And lower interest rates, of course, equate to budget savings for the Federal government. According to the "rules of thumb" published each year by the Congressional Budget Office, a 50 basis point decrease in interest rates would lead within a few years to more than $25 billion in annual Federal budget savings simply due to lower interest payments on outstanding government debt.[13]

In closing, Mr. Chairman, let me reiterate SIA's conviction that, by bringing back and modernizing the IRA, the 104th Congress will truly help America prepare for the economic future. Families will begin shoring up their household balance sheets. And the overall U.S. economy will be supplied the capital it needs to produce more jobs at higher wages.

In short, a revitalized IRA will be an important first step toward saving the American Dream.

# # #

Endnotes

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Mr. THOMAS. Thank you.
Mr. Hazen.

STATEMENT OF CHARLES E. HAZEN, SOUTHAMPTON, PA.

Mr. HAZEN. Good morning, Mr. Chairman and members of this committee. My name is Chuck Hazen. I reside in Southampton, Pa. I thank you for inviting me here to participate in our democratic process today. It is an opportunity I never had before and one I never expected to have. It reinforces my belief in our democracy and proves to me that our elected representatives do want to know what ordinary citizens think about the proposals that you may enact into law. I am proud to have this chance to be part of the lawmaking process. I want to thank those of you who saw fit to come sit to hear what I had to say this morning.

I was somewhat taken aback by a comment earlier this morning in testimony, in that the segment of the populace of which I am a member was categorized as being ordinary. I, on second thought, realized that that is in reality a compliment, and I thank you for that. It may even promote an inception of a lapel button of some sort.

As I understand my role, you want me as a private citizen to talk about the American dream savings account proposal. You also want me to talk about my belief that long-term care insurance is important to me and to the majority of people like me. I believe that the ADSAs, as I am told we can call these new savings accounts, would be a very good thing to make available to the American people. I also believe that almost every hardworking middle-class American would buy long-term care insurance if they knew what it does and if they could afford its cost.

One of the most interesting things about your ADSA proposal is that a person can combine the good features of saving through an ADSA, with a desire to buy long-term health insurance care.

Mr. Chairman, I am an average middle-class American, 64 years old and I work part time as a self-employed estimator for a contractor. I retired last year after a 30-year career as an insurance claims adjuster. My wife Peg and I have worked hard all our lives. We have raised and educated our children.

We have saved so we can enjoy an independent retirement. We want to do everything we can to assure in our remaining years we will have as much comfort in and choice of lifestyle as possible. We also want to leave a legacy for our children and grandchildren.

We believe in savings. We believe in planning. Peg and I believe that our government should make sure that people who cannot take care of themselves are cared for, but we also strongly believe in our own individual responsibility to take care of ourselves when we are able to do so. That means I have an obligation to consider the future and to plan and save so that my needs and the needs of my wife will be met.

Both Peg and I want our children and grandchildren to enjoy the fruits of our lifetime of labor. It is possible to make that happen. I don't want to spend my old age having my needs met by welfare or Medicare or the government. I don't want my wife to have to rely on the government to take care of her should she outlive me and need nursing home care.

As much as I do not want either Peg or me to end up relying on the government for our care in our old age, I also don't want to use up all our lifetime accumulated assets on nursing home care. I want something left for our children and grandchildren. That means I need and must purchase long-term care insurance.

We are now in the process of acquiring long-term health care insurance for both of us. The premium for the plans which would cover both of us would be $3,000 or $4,000 a year depending on the benefits level we select. For about $3,000 we can buy coverage that would pay us $130 maximum per day for up to 4 years of nursing home care for each of us. This particular policy also provides for a 5 percent per year inflation adjustment for 5 years.

This policy has a coverage level that is lower than I would like, but at this time, it is what we can best afford. I wish I would have addressed this need and the availability of this coverage 10 years ago. At age 54, the premium would have been about half of what it is at the present time.

I also wish ADSAs had been available 10 years ago. If they had been, I could have invested up to $2,000 a year for myself and another $2,000 a year for Peg in such an account. Then we could have accumulated sufficient money to buy the coverage I feel we really need. We then could have purchased a higher level of coverage.

It is not too late, of course. I am still working, and assuming this proposal becomes law and assuming the market creates competitive products, I would buy an ADSA even now. It is likely that I would seriously consider using some of the money we would save in an ADSA to enhance my long-term care coverage 5 years from now.

Mr. Chairman, I am 100 percent behind your proposal to create ADSA opportunities to save. For younger people, they represent wonderful opportunities to save for retirement, yet they still have flexibility. People would not have to wait until they are 59½ if they wanted to use their ADSA money to buy a first home, to pay for long-term care insurance, to cover the cost of their children's college educations, or to meet unexpected medical expenses.

It seems to me that this idea is a much more cost effective way for government to help citizens who believe, as Peg and I do, that if we can, we have an absolute responsibility to take care of ourselves and our family.

The tax advantage of an ADSA will be a big help in saving for retirement. Before retirement, it will be a big help for people who want to protect their lifestyle and their ability to choose how and where they will live, when and if they become too old to take care of themselves. In short, an ADSA that lets people save enough to buy adequate long-term care insurance can allow people who have worked and accumulated a nest egg to protect their dignity and their choice.

It will then leave a legacy for their children. It would allow them personal control and freedom even during old age.

I think that the ADSA proposal with emphasis on long-term care is also certain to save the government money in the long run. It will be less expensive to provide the tax subsidy to help people meet their personal responsibilities than it would be to finance the cost of governmental paid nursing home care. It is a proposal that will have only winners—individuals, families and the American people; because after all, the government when it is paying a bill is really you and me paying that bill. The government really is the American people.

Again, Mr. Chairman and members of the committee, I am proud to be here offering you my views on this proposal, which I certainly support. Thank you for this opportunity to participate.

If you have any questions, I will be glad to respond to them. Thank you.

Mr. THOMAS. Mr. Brennan.

STATEMENT OF JOHN J. BRENNAN, PRESIDENT, THE VANGUARD GROUP, ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE, WASHINGTON, D.C.

Mr. BRENNAN. Thank you, Mr. Chairman. Good morning.

I am John Brennan, president of The Vanguard Group. I appreciate this opportunity to testify today on behalf of the Investment Co. Institute, the national association of America's mutual funds industry.

The Institute's membership consists of some 5,000 mutual funds, including The Vanguard Group. Institute member funds serve more than 38 million shareholders and almost one-third of all U.S. households. Vanguard itself has over $130 billion in mutual fund assets under management, representing more than 4 million individuals. That sum includes $22 billion in individual retirement account (IRA) investments in 1.5 million IRA accounts.

Because our industry's primary focus is on saving and long-term investment, we are confronted daily with this sobering fact: America's personal savings rate is far too low. Government statistics show that personal saving as a percent of disposable personal income has tumbled over the last decade, from a level of 8 percent in 1984, to a low of 4 percent in 1993.

Most Americans recognize that fact. They are not confident their savings will be sufficient to meet their retirement needs. They doubt that Social Security benefits will fill that gap. Their dilemma is finding ways to save more in the face of stagnating household incomes, increasing costs and bigger tax bites.

One part of the message sent in November by middle-class voters all across America was a demand that Congress give them a fighting chance to provide for their long-term financial security. In effect, voters were saying: "We are willing to take our share of the responsibility for our personal futures, but we want some relief from tax burdens to help us do that."

Fortunately, we don't have to "reinvent the wheel" to find sensible middle-income tax relief that responds to that call. Expanding taxpayers' opportunities to save for the future by contributing to individual retirement accounts can accomplish that goal.

The Republican Contract With America offers an excellent starting point by proposing the American dream savings account, an IRA designed to meet retirement needs and increase personal savings.

Restoring families' full access to IRAs is the most responsible of all possible middle-class tax relief. We support combining the American dream savings account with legislation reestablishing universal access to a fully deductible IRA. That way individuals and families can choose to structure an investment program that best suits their particular needs. Providing IRA choices—this is the best way we believe to empower working families to save for their own future needs.

From a national perspective, the conclusion that IRAs increase personal savings is quite clear. To those who suggest that IRAs result in only a shifting of assets, I would note that financial institutions would not be so strongly supportive of expanded IRAs if it led to a mere shifting of money from one account to another. The experience of the mutual fund industry indicates that IRAs do in fact result in increased accumulations, not simply assets shifted from one pocket to the other.

While IRA choices are, in our view, the best answer, substantial experience in the IRA market has taught us another important lesson: A saving program that is not simple and marketable will not succeed. We cannot emphasize this enough: If an IRA is complex, it will not work.

If only tax accountants can understand it, they will be the only ones who use it. For savings incentives to work, the rules that govern them need to be stable and predictable. Frequent changes in the law create uncertainty and reduce contributions.

Our best recommendation is this: Make the IRA available as broadly as possible, keep it simple and make it permanent. You can be certain that enacting an IRA with complex rules and limitations will not work to increase personal savings.

I want to thank Chairman Archer and the committee for the opportunity to testify today on this issue of great importance to our Nation's future. I would be happy to answer any questions anyone might have.

[The prepared statement and attachment follow:]

TESTIMONY OF JOHN J. BRENNAN
INVESTMENT COMPANY INSTITUTE

Good morning, I am John J. Brennan, President of The Vanguard Group. I am testifying today on behalf of the Investment Company Institute, the national association of America's mutual fund industry. The Institute's membership consists of over 5,000 mutual funds, including The Vanguard Group. Institute member funds serve more than 38 million shareholders and almost one-in-three American households. Vanguard manages over $130 billion for more than 4 million individuals, nearly one half of those assets are invested through tax advantaged savings programs like Individual Retirement Accounts (IRAs) and 401(K) plans. I want to thank Chairman Archer and the Committee for the opportunity to testify today about an issue of great importance to our nation's future.

A. INTRODUCTION

Mutual funds permit millions of individuals to pool their savings in a fund professionally managed by an adviser who invests on their behalf in a wide variety of securities. Today, America's mutual funds serve an important financial management role for countless middle-income families -- not just the ranks of the wealthy. Median household income of mutual fund shareholders is approximately $50,000 a year.[1] Increasingly, mutual funds also serve as the investment medium for retirement programs, including employer-sponsored retirement plans and IRAs. As of December 1993, mutual funds held over $636 billion in retirement plan assets, of which $341 billion were IRA investments.[2]

Our industry's primary focus is on saving and long-term investment. For this reason, we are confronted daily with the sobering fact that America's personal saving rate is far too low. Most Americans realize this fact -- they are not confident their savings will be sufficient to meet their retirement needs, and they doubt Social Security benefits will be able to fill the gap. Their dilemma is finding ways to save more in the face of stagnating household incomes, increasing costs and bigger tax bites.

One part of the message sent in November by middle-class voters all across America was a demand that Congress give them a fighting chance to provide for their own long-term financial security. In effect, voters were saying: "We're willing to take our share of responsibility for our personal futures, but we want some relief from tax burdens to help us do that."

The Republican "Contract With America" responds directly to this need with the American Dream Savings Account, a type of IRA designed to meet retirement needs and increase personal saving. We enthusiastically support that proposal. By expanding the IRA options available to middle-class Americans, the American Dream Savings Account will provide direct, tangible tax relief by letting Americans save more and plan for retirement. We urge the Committee and the House to act promptly on this proposal.

B. AMERICA IS NOT ADEQUATELY PREPARING FOR RETIREMENT

There is a clear need for Congress to establish a more powerful incentive to increase retirement saving. Future retirees will have a longer life expectancy and, therefore, a longer retirement period than prior generations. It is also well known that the increasing cost of maintaining Social Security benefits must be funded by a shrinking work force. When the so-called "baby boom" generation (born between

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[1] Profiles of Mutual Fund Shareholders, Investment Company Institute (Fall 1992).

[2] Annual Mutual Fund Pension Statistics, Investment Company Institute (August 1994).

1946 and 1964) reaches retirement, there will be more retirees supported by fewer workers than ever before. Today, for each person 65 and older there are almost 5 persons between 20 and 64; when today's younger workers reach retirement in 2040, there will be only an estimated 2.7 persons between 20 and 64 for each person 65 and older.[3] In fact, the Social Security Administration reports that the program is insufficiently funded in the long run, and that it is projected to have a negative cash flow by approximately the year 2013.[4]

Recent studies indicate that even if our current mix of entitlement obligations and taxes remains unchanged, today's low saving rates could leave 46 million members of the "baby boom" generation with retirement living standards lower than today's median for 65 year-olds.[5] Even under that scenario, described as "an optimistic extreme," they conclude that future generations will need more private saving to provide them with as much purchasing power as current retirees.

This is not going unnoticed by the American people. A survey released in December 1994 by the Employee Benefit Research Institute reports that roughly two-thirds of Americans age 26 and over are not confident that Social Security will continue to provide benefits of equal value to the benefits received by retirees today.[6]

What are Americans doing in the face of this increased need for personal retirement saving? Unfortunately, they are saving less than ever before.

Government statistics show that personal saving as a percent of disposable personal income has tumbled over the last decade -- from a high of 8.0% in 1984, to a low of 4.0% in 1993.[7] If government deficits are factored in, the situation appears even more bleak: since the 1960s, "net national saving" has dropped from more than 8% to less than 2% today.[8]

The Institute has been concerned about the falling saving rate for some time. An Institute study released three years ago confirmed that, compared to other generations, the Baby Boom generation seems much less prepared financially for their retirement years. Despite a higher number of two-income families and a considerably higher per capita income than previous generations, their saving rates are lower than the two generations that preceded them. The study found that

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[3] Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund, 1994 Annual Report (U.S. Government Printing Office, 1994); Bipartisan Commission on Entitlement and Tax Reform, "Interim Report to the President" (August 1994).

[4] Ibid.

[5] See "Saving the American Dream," An Economic and Public Opinion Study Sponsored by Merrill, Lynch & Co., Inc. (1994); Auerback, Alan J. and Kotlikoff, Laurence J., "U.S. Fiscal and Saving Crisis and Their Impact for Baby Boomers" (May 1994), printed in Employee Benefit Research Institute, " Retirement In The 21st Century -- Ready Or Not," EBRI Policy Forum (1994).

[6] Employee Benefit Research Institute, "Retirement Confidence In America: Getting Ready For Tomorrow," EBRI Special Report SR-27/Issue Brief No. 156 (December 1994).

[7] Economic Report of the President, Transmitted to the Congress February 1994 (United States Government Printing Office), Table B-27.

[8] Bipartisan Commission on Entitlement and Tax Reform, "Interim Report to the President" (August 1994).

more than 6 out of every 10 Baby Boomers state that they are not saving for retirement, even though more than half expressed worry about meeting their financial needs during retirement.[9] Subsequent research only confirms these alarming trends.[10]

The evidence is overwhelming. Saving by America's middle class is simply not keeping pace with future needs. The prospects looking forward are unsettling. A policy response by government is imperative.

C. EXPANDING IRA OPTIONS IS AN EFFECTIVE POLICY RESPONSE

The Institute strongly believes that the best policy response is legislation to enhance individual retirement saving. We believe IRA options that are easy to understand and consistently maintained, can and will increase personal saving -- and help alleviate this coming national crisis.

Strong academic evidence supports the conclusion that IRAs do increase saving and do result in new saving.[11] A stable program, consistently maintained, will produce increased saving, not just a shifting of assets into tax-favored retirement programs. A saving habit can be developed through the use of an effective marketing campaign that reinforces the benefits of regular saving.

The psychological impact of an IRA on saving behavior should not be underestimated.[12] Common sense dictates that an IRA is more likely to produce long-term retirement saving than short-term saving vehicles. Money in your wallet is more tempting to spend than money in the checking account, which, in turn, is more tempting than a saving account. Even less tempting are funds set aside for retirement, such as money in an IRA. **We believe that money in an IRA is less likely to be spent than money in a savings account, so IRAs will increase long term saving even if all the money put into IRAs would have been put into some other shorter term saving account.**

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[9] "The Baby Boom Generation, A Financial Portrait," Investment Company Institute (Spring 1991).

[10] According to research performed for Merrill Lynch, half of American families currently only have approximately $1,000 in net financial assets. Anderson, Joseph M., "The Wealth of U.S. Families In 1991 and 1993," Capital Research Associates (December 1994). "Net financial assets" as used in the study include checking, savings and money market deposit accounts, CDs, stocks, bonds, mutual fund shares, IRA and Keogh accounts, 401(k) accounts, and other financial instruments, less unsecured debt (such as unpaid bills, bank debt and credit card balances) and debt secured by financial assets. Employer pension fund accruals are not included in net financial assets. See also, Employee Benefit Research Institute, " Retirement In The 21st Century -- Ready Or Not," EBRI Policy Forum (1994) and Employee Benefit Research Institute, "Public Attitudes on Retirement Income," EBRI Report G-55 (1994)

[11] See, e.g., Hubbard, R. Glenn and Skinner, Jonathan, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 1995)(includes a discussion of the major research papers); Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994); Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994); Skinner, Jonathan, "Individual Retirement Accounts: A Review of the Evidence," printed at 54 Tax Notes 201 (January 1992)(includes collection of citations to relevant research studies by Professor Skinner and others); Venti, Steven F. and Wise, David A., "The Evidence On IRAs," printed at 38 Tax Notes 411 (January 1988)(includes discussion and collection of citations to earlier series of papers by Professors Venti and Wise).

[12] Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

In the end, of course, all the statistics, scholarly research and academic studies in this area must give way to basic instinct and business judgment. The Institute and its members have made expanding the IRA our highest legislative priority, and we expect that the banking and brokerage industries share a similar objective.

That may be the clearest and most compelling testimony of all. What it is saying is that the investment and money management firms in the nation -- including many household names like Merrill Lynch, Fidelity, IDS, T.Rowe Price and Vanguard -- are convinced that expanding the IRA will significantly increase net saving by encouraging people to save more and over longer periods of time.

We would respectfully submit that, in the debate on whether IRAs contribute to net savings, deference be paid to the collective business judgment of the marketplace, which has proven its efficiency in the past in identifying opportunities for increasing investment saving.

D. EXPANDING IRA OPTIONS WOULD BENEFIT MIDDLE-INCOME FAMILIES

Because IRAs reduce taxes paid on income, they sometimes have been criticized as benefiting primarily the wealthy. Yet the evidence suggests the contrary -- **most contributions to IRAs are made by middle-income families.**

At the IRA program's peak in 1986, 75 percent of all IRA contributions were accounted for by families with annual incomes of less than $50,000.[13] **Moreover, it has been shown that, before its discontinuance, the universal IRA was increasingly attracting contributions from lower income brackets.** In the period of 1982 - 1986, the median income of new contributors (expressed in 1984 dollars) dropped an average of 24 percent, i.e., from $41,277 in 1982 to $28,677 in 1986.[14]

The best proof that IRAs are not "tax breaks for the rich" is the simple fact that expanding IRA options is undeniably viewed as important by America's middle-class voters. Frank Luntz, a prominent national pollster, has reported that a recent poll of the American public on budget, deficit and Social Security issues found that 65 percent of respondents felt strongly that Congress should restore tax deductible IRAs for all income levels. In fact, enhancing IRAs was the single most popular of all the tax proposals in the poll.[15]

The Congress should not, however, judge IRA expansion proposals solely on the basis of their popularity. All tax cuts are popular. America needs responsible tax cuts -- ones that increase saving, spur investment and do so without overstraining fiscal policy. Fortunately, we don't have to reinvent the wheel to find such a tax cut. Expanding taxpayers' opportunity to contribute to IRAs meets all of these sensible criteria.

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[13] Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994). IRA participation is also closely related to age. Nearly 50 percent of all families in the 55-65 age group had an IRA account. Thus, even though less than one-third of all families have an IRA at any single point in time, Professor Venti concluded that over their lifetimes, at least half of all families could be expected to participate in an IRA program.

[14] J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992).

[15] Luntz Research Companies, "Budget and Contract Post-Election Survey" (1994).

E. ENACTING IRA LEGISLATION NOW IS AN ESSENTIAL STEP TOWARD CURING OUR PERSONAL SAVING SHORTFALL

Proposals to expand the IRA have gained strong and well-deserved bipartisan support, and they include a number of thoughtful approaches.

The Republican "Contract With America" offers a new "American Dream Savings Account" that allows a non-deductible annual contribution of up to $4,000 for a married couple ($2,000 for an individual). If the account is held for five years, the taxpayer could withdraw funds tax-free and without penalty for retirement, first time home purchases, higher education or medical expenses.[16]

The Administration's proposal would expand tax-deductible IRAs and would permit the use of pre-retirement withdrawals to pay for first home purchases, higher education expenses, catastrophic health care expenses, long-term unemployment, or the care of an elderly parent. The Administration proposes to raise the current tax deductible IRA income limit for couples from $40,000 (phasing out at $50,000) to $80,000 (phasing out at $100,000). The Administration also would allow individuals the option of the "back-end IRA" for non-deductible contributions to an IRA, with the earnings exempt from tax when withdrawn.[17]

Congressmen Thomas and Neal recently introduced H.R. 682, The Saving and Investment Incentive Act of 1995, which would restore a fully deductible front-end IRA and establish a nondeductible, tax-free back-end IRA. The Senate is also, once again, active in this area. Senators Roth and Breaux have introduced a bill similar to H.R. 682.[18]

Some of these IRA proposals include provisions that would allow non-wage-earning spouses and spouses of workers covered by retirement plans to make full IRA contributions. These elements of the proposals are important steps that will help provide spouses with greater financial security. We strongly support spousal eligibility as a vital element of any IRA measure that Congress adopts.

In the final analysis, all of these IRA options respond directly to the need to increase personal saving. Congress can act most effectively by giving Americans a choice of IRA vehicles. That way individuals can choose to structure an IRA investment program that best suits their particular needs. Some may want the tax-free distribution option of the back-end IRA like that in the American Dream Savings Account, while others may find the immediate tax deduction of the front-end IRA is the incentive they need to save. Still others may want to divide their IRA contribution into front- and back-end IRAs.

While IRA choices are, in our view, the best answer, the mutual fund industry's substantial **experience in the IRA market has taught us an important lesson: a saving program which is not amenable to a simple marketing campaign is not likely to be as effective as Congress would like.** Economic studies on IRAs and

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[16] H.R.6, The American Dream Restoration Act.

[17] See U.S. Department of the Treasury, Treasury News, "Tax Cut Proposals In President Clinton's Middle Class Bill of Rights" (December 16, 1994).

[18] See, S. 12, The Savings and Investment Incentive Act of 1995.

saving have concluded that marketing plays a role in IRA purchases.[19] An IRA saving program that is easy to understand is most likely to be successful.

To doubt the importance of "marketing" and "marketability" to a successful saving initiative is to ignore the realities of the marketplace. We all can attest to the barrage of advertisements that pervade television, radio, newspapers, magazines, and billboards urging us to buy, spend, and consume. To promote saving you also need an effective "message" that encourages people to save and invest for their and their family's future. The saving record compiled between 1982 and 1986 proves the point. **When virtually all Americans enjoyed access to a simple, universally deductible IRA, financial institutions across the country actively promoted and marketed them as saving programs. As a result, millions of families invested more than $250 billion in just four years.** The IRA experience since 1986 is just the opposite and some studies have suggested the post-1986 drop off in IRA saving could be attributable to the greater difficulty financial institutions faced in trying to market the more complicated post-1986 IRA.[20] IRA legislation with multiple limits, set offs, exceptions, exclusions, rules and other technicalities cannot be effectively marketed, because the IRA it produces cannot be effectively explained to most Americans. We cannot emphasize enough, if an IRA is marked by complexity, it will not work! If only tax accountants can understand it, they will be the only ones to use it.

Moreover, for saving incentives to work, the rules that govern them need to be stable and predictable. Frequent changes in the law create uncertainty and reduce contributions. Such changes do not just confuse individual savers. They also undercut the willingness of financial institutions to make costly, long-term investments in marketing these saving programs to the public. **Our best recommendation: make the IRA available as broadly as possible; keep it simple; make it permanent.**

F. STRENGTHENING OTHER RETIREMENT SAVING PROGRAMS CAN ENHANCE SAVING

In our view, there are other simple actions that would promote retirement security of American workers, and other aspects of the retirement saving problem need to be addressed now.

Pension plan coverage in the small employer sector requires urgent attention. One of the major distinctions between the small employer (i.e., one with 100 or fewer

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[19] See, e.g., J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992). Skinner also reported that a large fraction of IRA households contributed exactly $2,000 even when each spouse was eligible to contribute $2,000. He cited the IRA marketing campaign's focus on the $2,000 contribution limit for individuals as a possible explanation. Ibid.; Feenberg, D. and Skinner, J. "Sources of IRA Saving," Tax Policy and the Economy (3d ed. L.Summers) (1989).

[20] In a recent article discussing the role of tax policy in shaping middle class tax cuts, Gene Steuerle, a Senior Fellow at the Urban Institute, said: "There is a fair amount of evidence that the current system adds enough complexity to deter saving in these [individual retirement] accounts. Thus, when IRA deductions were limited by income class, even those who did not face those new income limitations cut back on their IRA saving. One reason, perhaps, was that banks, mutual funds, and other institutions found it much more difficult to advertise these accounts in any simple way. If the simplification goal is important, then one would need to be careful not to add too many bells and whistles onto bills expanding IRA account availability." Steuerle, G., "Middle-Class Tax Cuts and Principles of Tax Policy," Tax Notes p. 1722 (December 26, 1994). See also Summers, Lawrence H., "How Best to Give Tax Incentives for Saving and Investment?" Testimony Before the Senate Finance Committee (September 29, 1989); J. Skinner, "Individual Retirement Accounts: "A Review of the Evidence," 54 Tax Notes 201 (January 1992).

employees) and larger employers is in the retirement plan area. As of 1993, only 29 percent of the employees who worked for a small employer worked for a company that offered a retirement plan, as compared with 83 percent in the larger companies.[21]

In our view, the simplified employee pension, or "SEP," is an under-utilized retirement plan vehicle through which small employers not currently maintaining retirement plans could be encouraged to provide retirement income for their employees.[22] The SEP is a simple, easy-to-administer retirement plan ideally suited for the small employer market, where coverage is woefully inadequate.

A variant of the SEP, a salary reduction SEP or SARSEP, has become increasingly popular in the small employer market. Modest changes in the current legal restrictions on the salary reduction SEP would make it more attractive to small employers and should increase coverage substantially. For example, simplifying both the 401(k) and the salary reduction SEP nondiscrimination rules would ease the burdens on small employers, promote greater retirement plan coverage and increase retirement saving. The Institute also recommends expanding the class of employers that could take advantage of the salary reduction SEP beyond the current "25 or fewer employees" size limit, and eliminating the requirement that at least 50% of the employees of the employer eligible to participate must elect to have salary reduction contributions made to the SEP. Each of these changes can be simply implemented.

G. CONCLUSION

Today's IRA savings are already one of the pillars of the American Dream -- because they are helping millions of families secure their future retirements through investments that help create saving, jobs and economic growth now. By working together to expand IRA options and restore full IRA eligibility to the middle class, we can empower millions more families to realize their own American Dreams.

Thank you again, Mr. Chairman, and the other members of this Committee, for permitting me to testify.

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[21] See Employee Benefit Research Institute, "Employment-Based Retirement Benefits: Analysis of the April 1993 Current Population Survey," EBRI Issue Brief No. 153 (September 1994).

[22] A SEP is an employer-sponsored arrangement through which the employer makes contributions to IRAs maintained for individual employees in accordance with a written plan. The SEP can be simply established by an employer completing five boxes on a half-page pre-printed IRS form. The employer does not need a lawyer, actuary or pension consultant to establish or maintain the SEP.

APPENDIX

INVESTMENT COMPANY INSTITUTE

SYNOPSIS OF ACADEMIC STUDIES ON THE IRA'S EFFECTIVENESS AS A SAVING INCENTIVE

The Institute has long supported legislative efforts to enhance individual retirement saving. A great deal of research has been done in recent years on the effectiveness of IRAs as incentives designed to increase personal saving. The primary issue on which many of these studies focus is whether the IRA tax incentive produces new saving or a windfall to typically higher income groups. Would IRA contributors have saved the money anyway, such that their contributions are simply assets shuffled from taxable to tax-favored accounts that do not increase overall personal saving? The mutual fund industry's experience has convinced us that IRA saving options that are easy to understand and consistently maintained can and do increase personal saving. This appendix is a synopsis of the work of a number of prominent scholars who have concluded that IRAs do result in new saving.

In a January, 1995 study, Professor R. Glenn Hubbard of Columbia University and Professor Jonathan Skinner of the University of Virginia published several important conclusions.[1] They focused on whether savings incentives like the IRA are likely to improve households' financial resources in retirement. They found evidence that IRAs and 401(k) plans account for between one-fifth and one-half of financial wealth among lower-middle-income households. They also found that most researchers studying saving incentives agree that in the long run, 401(k)s and IRAs have an important positive impact on saving behavior. For example, they cited recent calculations by economists suggesting that increasing the limit on IRA contributions will increase net national saving by $4 for every $1 reduction in tax revenue. They conclude that a long-term saving strategy for the U.S. Government should include saving incentives such as IRAs and 401(k) plans, and that since saving incentives appear most effective in the long term, policies introduced to encourage saving should remain in place.

In an earlier study, Professor Skinner studied IRS tax return tapes containing a sample of more than 5,000 tax returns filed for the years 1982-1986, to reexamine the evidence on the effectiveness of the IRA program.[2] He found that the IRS data "suggests a strong persistence in IRA purchases, with the probability of contributing to an IRA -- given enrollment in the prior year -- remaining over 80 percent during the entire period 1982-1986." In other words, he concluded that IRAs are a good way for individuals to contribute to their saving -- they do create new saving -- by ingraining the saving habit. Professor Skinner's study also cited data showing that, before its discontinuation, the universal IRA was increasingly attracting contributions from lower income brackets. Again using the IRS tapes of tax returns, Skinner found differences between those who first contributed in 1982, and subsequent new contributors. In the period of 1982-1986, the median income of new contributors (expressed in 1984 dollars) dropped an average of 24 percent, i.e., from $41,277 in 1982 to only $28,677 in 1986, although the fraction of new enrollees was low in that final year.

Dartmouth Professor Steven Venti has spent nearly a decade studying the saving effectiveness of what he calls "targeted retirement saving programs," such as IRAs, that allow individuals to save on their own behalf for the specific purpose of financing consumption in retirement. In recent testimony before a Senate Finance Subcommittee, he examined saving data from the Survey of Income and Program Participation for three different age groups

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[1] J. Skinner & R.G. Hubbard, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 19, 1995).

[2] J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992) (study also reviews earlier research done by Professor Skinner and others).

(families reaching age 60 to 64 in 1984, 1987 and 1991).[3] Dr. Venti found an "astounding" increase in asset balances the longer the family has been exposed to targeted retirement programs. The typical family with the longest exposure to targeted retirement savings programs -- those with nine years of exposure -- had nearly three times the targeted retirement assets of the typical family with only two years of exposure. He noted a comparable increase in total assets as well. Dr. Venti concluded that since total financial assets, including balances in IRAs, are much larger for the younger cohort than for the older cohort, that suggested that targeted retirement saving programs did stimulate new saving over the period, not just a shifting of saving from taxable accounts into tax deferred retirement accounts. He went on to conclude that "the weight of the evidence shows that these targeted retirement saving programs do increase saving."

Further according to Professor Venti, at the IRA program's peak in 1986, about 16 percent of tax filers contributed to an IRA, and about 29 percent of all families with heads of households under age 65 had positive IRA balances. While the likelihood of households having an IRA increased with income and age, at the peak of the program, 75 percent of all IRA contributions were accounted for by families with annual incomes less than $50,000.[4]

Professor Venti also has done a series of papers with Professor David A. Wise of Harvard University in which they examined saving.[5] In their 1991 paper, they estimate that fully 66% of the increase in IRA contributions comes at the expense of current consumption; 31% comes from the tax subsidy, and only 3% comes from a reshuffling of existing saving. That is, that IRA contributions do represent new saving.

Professor Richard Thaler of Cornell agrees that, over time, the households that contribute to IRAs and 401(k) accounts accumulate assets in those accounts rapidly, rarely draw them down before retirement, and show no signs of reducing assets in other accounts.[6] He further argues that recent experience with the IRA suggests that saving is as much a psychological as an economic decision. Specifically, Professor Thaler explains that households allocate funds, implicitly or explicitly into categories, or "mental accounts." "Some funds, e.g., those in cash or checking accounts, are designed for current consumption. Others, e.g., those in savings accounts, are for 'rainy days' or 'special occasions'." The various accounts differ in how "tempting they are to invade. Money in your wallet is more tempting to spend than money in the checking account, which in turn is more tempting than a savings account. Even less tempting are funds explicitly set aside for retirement, such as money in an IRA or 401(k) plan." Professor Thaler notes that while some economists have argued that IRAs simply shifted assets from taxable savings accounts into a tax sheltered IRA, those "studies fail to take into consideration that money in an IRA is less likely to be spent than money in a savings account." He argues that once this concept is acknowledged, IRAs can increase long-term saving even if all the money put into IRAs would have been put into some other shorter term saving account.

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[3] Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

[4] Professor Venti also found that IRA participation is also closely related to age. Nearly 50 percent of all families in the 55-65 age group had an IRA account. Professor Venit concluded that "even though less than one-third of all families have an IRA at any single point in time, over their lifetimes at least half of all families could be expected to participate in an IRA program." Venti, Steven F., "Promoting Saving For Retirement Security," Testimony for the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

[5] See, e.g., S. Venti & D. Wise, "The Evidence On IRAs," 38 Tax Notes 411 (January 1988) and J. Skinner & R.G. Hubbard, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 19, 1995) (including citation and discussion of the Venti & Wise 1991 paper).

[6] Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

Mr. THOMAS. Thank you.
Mr. Gale.

STATEMENT OF WILLIAM G. GALE, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. GALE. I thank you for the invitation to testify at this hearing. My testimony is based on research that I have conducted over the past 5 years on the effects of IRAs and 401(k) plans on private saving and national saving.

Let me say at the outset that I agree with every other witness that has appeared this morning that low rates of saving and low rates of investment are one of our Nation's most important economic issues. Nevertheless, I do not support expanding the IRA system, because I believe that the evidence shows that it will lead to little, if any, addition to private saving and could possibly reduce national savings.

I should add that I say this reluctantly. I would love to come here and tell you that there is a quick painless way to fix the decline in savings, but, unfortunately, that is not what the facts say. This is a situation where when something seems to be too good to be true, it probably is. So in my testimony, I would like to talk you through basic elements of my reasoning and the evidence that supports this conclusion. I will focus on four points.

Point one is the overall saving rate. A number of people have mentioned that since the early eighties, the overall saving rate has fallen. You should note that since 1981, total balances in IRA plans, 401(k) plans and Keogh plans have increased by $1.5 trillion—$1.5 trillion represents about 7 years' worth of personal saving, so in the last 13 years these accounts alone have accumulated 7 years' worth of personal savings.

If these amounts represented new saving, it would not be too much to ask that this type of accumulation in 13 years would show up as an increase in the personal savings rate. In fact, as everyone today has mentioned, the personal savings rate has fallen rather than increased over this time period. There is no evidence from aggregate savings rates that saving incentives have had any positive effect on the overall saving rate.

Point two is that saving incentives are poorly designed from an economic perspective. There are two aspects to this: The first is unavoidable, and that is higher interest rates, believe it or not, do not always raise savings. Sometimes they reduce savings.

I am sure you are familiar with examples where higher interest rates raise saving, so let me give you an example of how they might reduce saving. Suppose you have a worker that goes to a financial planner and the planner says that the worker should save enough so that retirement income is equal to 70 percent of income during working years.

The simple fact is, if the worker aims for that goal, the higher the interest rate, the less the worker has to save. At a 20 percent interest rate, the worker needs to put away less than at a 5 percent interest rate.

The second issue is even more fundamental. You don't have to save to have an IRA. Saving more means consuming less or spending less. To put it in the boldest possible terms; saving more means reducing your current standard of living. People naturally find that painful. People don't like to reduce their current standard of living.

But people love IRAs. Why? The answer is that most people that use IRAs can put the money into the IRA and get the tax benefit without reducing their standard of living. How can you do this? There are several ways, some of which have been mentioned by the earlier witnesses.

First, you can take taxable assets that you already own and put them in an IRA; second, you can take current or future saving that you would have done outside the IRA and put them into the IRA; and third, you could take a loan and put the proceeds into an IRA.

The good news for people doing these things is that they don't have to reduce their living standards and they still get the tax benefit. The bad news for policymakers is twofold. First, if this is how people contribute to IRAs, there is no increase in private saving; and second, there is an increase in the budget deficit. So point two is that the items are designed poorly from an economic perspective.

Point three is the evidence on who contributes to IRAs and what it means. The basic fact is that households with IRAs are much, much wealthier than households without IRAs. In 1986 they had seven times the amount of non-IRA financial assets, four times as much net worth and eight times as much saving.

Why does this matter? It shows that the households with IRAs have very high levels of preexisting wealth and very high levels of current savings. Hence, when witnesses say that the typical household in the economy has little saving and, therefore, can't shift money into an IRA, that is true, but it is irrelevant because the typical household does not have an IRA. Households that do have IRAs have lots of assets and lots of saving that they can easily shift into IRAs and, therefore, get the painless tax break rather than the painful one.

Let me close on point four, which is that I am one of those IRA opponents who allegedly is coming around to view IRAs favorably, according to the survey that was mentioned earlier. This is a draft survey. I feel it is highly irresponsible of the association to issue a draft survey into the public domain. I have sent the authors 12 pages of comments noting factual errors and logical inconsistencies in their study. But the point that is alleged to be my change of opinion, is that after 70 years, IRAs would raise the saving rate by one-quarter of 1 percentage point, for example from 4 percent to 4.25 percent. But first, that effect takes 70 years. Second, the model that generates that effect shows that IRAs reduce saving for the first 35 years. So the point of the model is that if you are willing to accept a reduction in saving for the first 35 years, then you can get some benefit after that. But I would add, if you are really interested in the 70-year horizon, the right thing to do is to rein in Social Security.

Thank you very much. I would be happy to answer any questions.

[The prepared statement follows:]

Testimony of

William G. Gale
Senior Fellow, The Brookings Institution

before the
House of Representatives
Committee on Ways and Means

Tuesday, January 31, 1995

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify on the desirability of expanding Individual Retirement Accounts.

My testimony consists of three parts: a brief summary of the main conclusions; a fuller exposition of the reasoning behind those conclusions; and a brief concluding statement about alternative ways to raise national and private saving.

Main Conclusions

o The low level of national saving and capital formation is the most important economic problem our country faces. Nevertheless, I do not advocate expanding the IRA program, because I believe that doing so would generate little if any increase in national saving and could possibly reduce saving.

o IRAs, and similar programs like Keogh plans and 401(k) plans, are designed poorly from an economic perspective.

o Despite the $1.5 trillion increase in balances in these accounts since 1981, the personal, private and national saving rates have fallen by substantial amounts.

o Most IRA contributions between 1982 and 1986 (the "golden period" of IRAs) were made by two groups of people: those with very high levels of non-IRA assets and those who were 59 or older. It is likely that contributions by these groups do not represent net additions to private or national saving.

o Highly stylized research models suggest that IRAs may raise the national saving rate in the long run (35 years or more). These results, however, are speculative, are subject to a number of important qualifications, and thus may not be a very good guide to current policy.

o The surest way to raise national saving would be to reduce the deficit in ways that do not reduce private saving. Raising private saving further may prove to be a difficult challenge, but attention should focus on the pension system.

Saving Incentives and The Saving Decline

American saving rates have recently fallen to their lowest levels in decades. These declines have raised concerns that the economy may be unable to finance investment and sustain growth over the long run, and that a significant fraction of the population may not be saving adequately for retirement. As a consequence, raising the saving rate has been a frequent focus of policymakers. One popular legislative remedy for stimulating saving has been the development of special, designated saving accounts, such as Individual Retirement Accounts, 401(k) plans, and Keogh accounts. These accounts, which I refer to as "saving incentives," feature preferential tax treatment of contributions and investment earnings, annual contribution limits, and penalties for early withdrawals.

IRAs were established in 1974 for workers without pensions. In 1981, eligibility was extended to all workers and the limits were raised to their current levels. For a single worker, the limit is the minimum of earnings or $2000. The presence of a spouse raises the limit by $250. In a two-worker household, the limit is the minimum of earnings or $2000 for each worker, so the maximum combined limit is $4000. From 1982 to 1986, eligibility was universal and contributions were tax-deductible. In the Tax Reform Act of 1986 (TRA86) deductibility was phased out (eliminated) for household with a retirement plan when adjusted gross income exceeded $40,000 ($50,000) for joint tax-filers, and $25,000 ($35,000) for single tax-filers. TRA86 did not restrict IRA eligibility or the tax-free accrual of interest.

401(k)-type plans are similar to IRAs but are available only to workers at firms or other organizations that choose to sponsor the plans. Employees may make tax-deductible contributions. Employers may make independent or matching contributions. The legal annual contribution limit was $9,240 in 1994, but firm-imposed limits and non-discrimination rules reduce the limit substantially for many participants. Keogh plans are similar to IRAs but have higher limits and are directed toward self-employed persons.

Contributions to IRAs averaged about $35 billion during 1982-6 when contributions were fully deductible, but fell by about 75 percent after the TRA86 changes. 401(k) contributions have risen from virtually zero in 1982 to about $60 billion in 1994. KEOGH contributions have remained under $10 billion per year.

These programs have been very popular, but they may not have raised private and national saving. This would be true, for example, if the contributions to saving incentives were financed by shifting money from other existing assets or by redirecting saving that would otherwise have been placed in other assets.

One preliminary way to get a sense of the effects of saving incentives is to examine aggregate trends in saving. Since 1983, contributions to saving incentive plans have amounted to one-third or more of personal saving as conventionally measured. Moreover, from 1981 to 1993, assets in saving incentive accounts rose by almost $1.5 trillion. Since personal saving is about $200 billion per year, saving incentive accounts, in just 12 years, accumulated balances worth about 7 years of personal saving. It would not be unreasonable to expect accumulations of this magnitude to show up as increases in the personal saving rate. However, rather than rising, the personal saving rate fell by almost half over this period.

These trends should be interpreted with caution, however. Economists are unsure about the causes of the saving decline, and many factors affect aggregate saving. Nonetheless, it is clear that saving incentives are large relative to personal saving, and that trends in personal saving show no sign that saving incentives have increased saving.

<u>Do Saving Incentives Stimulate Saving?</u>

The effect of saving incentive plans on national saving is the sum of their effect on private saving and government saving.

<u>Private Saving:</u> Standard economic theory indicates that raising the after-tax rate of return on <u>all</u> saving creates two effects that work in opposite directions and hence may raise or reduce saving. The obvious effect is that the higher return raises the reward to saving and thereby encourages people to undertake more saving. Economists refer to this as a price or substitution effect. The second effect is less obvious but just as real. With higher interest rates, people can save less and still reach a given wealth target. Economists refer to this as an income effect. The income effect reduces the amount that people save in response to an increase in the rate of return. For example, suppose that a worker is saving for retirement with the goal of generating retirement income equal to, some fraction (say, 70 percent) of pre-retirement income. (This is a common financial planning approach to retirement saving.) The higher the interest rate, the less the worker needs to save to reach this goal.

How would this worker respond to an increase in interest rates? For a given target level of retirement income, the worker would save less than before (the income effect). But the worker may very well raise his retirement income goal (the substitution effect). If the increase in his goal is small, the income effect will dominate and saving will fall. If the increase in his goal is large enough, the substitution effect will dominate and saving will rise. Therefore, both the size and the direction of the effect of higher interest rates on all saving is ambiguous. Most empirical estimates and realistic simulation models suggest that the response is not very big.

Saving incentives do not raise the after-tax return on all saving, only on a limited amount of contributions placed in a designated account. For at least two reasons, this may be an even less likely way to raise saving than raising the return on all saving. First, oddly enough, so-called saving incentives do not require that contributors <u>save</u>, or save more than they would have otherwise. Saving requires a reduction in current consumption (or an increase in labor supply). But contributions to saving incentive accounts may be financed by transferring existing taxable assets, by increasing debt, or by reallocating saving that would have been done even if the incentive had not existed. In each of these cases, the contribution will not represent a net addition to private saving.

Contributions will be most likely to be financed by one of the latter methods for two types of households. The first is households that hold large amount of other assets. These households have more assets to shift and less of a need to maintain all of their assets as precautions against emergencies. The second is older households, who are less likely to face a binding early withdrawal penalty. In the extreme, people older than 59.5 years face no early withdrawal penalties. In each case, IRAs are good substitutes for the saving those households would do anyway, so the IRA contribution will be unlikely to represent new saving. In contrast, contributions will represent a net addition to saving only when they are financed by reductions in consumption, which will occur only when IRAs and other saving are poor substitutes for one another. This is more likely to occur for households that have lower asset holdings, and are younger.

The second problem is that because the subsidies in saving incentive plans are capped by an annual contribution limit, the saving incentive will not affect marginal returns to saving for high-saving households. Rather, for those households the incentive will generate only an income effect, which should reduce their saving. Both of these problems imply that the effects of IRAs on private saving will depend critically on who contributes to IRAs. I examine this issue below.

Public Saving The effects on public saving are also important to consider. To the extent that contributions do not represent new private saving, the effects on public saving are strong and negative for two reasons. First, the tax rate faced by a household during retirement (when withdrawals are typically made) is usually lower than that faced by the same household during working years (when contributions are made). Second, some tax revenues are lost on the accumulated interest because investment earnings on IRA balances are taxed only when they are withdrawn. For example, if the tax rate during working years is 30 percent, the tax rate during retirement is 15 percent, the interest rate is 10 percent and the holding period is 15 years, the present value of tax revenues from a dollar of pre-tax income put into an IRA is 15 cents, but the present value of tax revenues from the same dollar of pre-tax income placed in a taxable account is 54 cents. Hence, in present value terms, the government loses 39 cents. This is larger than the 1 period revenue loss that would be recorded in the budget, 30 cents. If the holding period is 30 years, the present value loss is 55 cents. Thus, in the absence of other policy changes, a saving incentive plan must not only raise private saving but raise it by more than the associated tax loss to the government in order to raise national saving.

Who contributed to IRAs and Why It Matters

One step toward determining the effects of IRAs on saving is to focus on the characteristics of IRA contributors. The table below reports characteristics of different types of households in 1986.[1] The table describes the median or typical household in each category. All dollar figures are in 1986 dollars.

	All Households	Households without IRAs	Households with IRAs	Households that contributed to the Limit 3 years in a row
Age	49	49	50	51
Annual Income	$21,320	$15,667	$35,000	$44,500
Non-IRA Financial Assets	$6,000	$3,000	$21,695	$41,269
Net Worth	$42,710	$25,470	$107,946	$188,943
Saving (Change in Net worth, 1983-6)	$6,129	$2,884	$23,500	$60,691

[1]The table is taken from William G. Gale and John Karl Scholz, "IRAs and Household Saving," American Economic Review, December, 1994.

The table shows that households with IRAs are very different from households that do not have IRAs. In particular, compared to households without IRAs, the typical household with an IRA has seven times the non-IRA financial assets, four times the overall net worth, and eight times the saving. Some of these differences are due to differences in other variables like income or age, but even after controlling for these factors, there are large differences in the underlying saving behavior of household with and without IRAs that can not be explained by IRAs.

These facts have several important implications for understanding how IRAs affect saving. First, these differences complicate the task of measuring the effect of IRAs on saving. Studies that compare IRA contributors and non-contributors have to somehow disentangle the "IRA effect" from the "different underlying saving behavior effect." To see this, suppose there exist two groups: "large" savers and "small" savers. We would expect to see that IRA holders (where large savers are overrepresented) would save more than non-IRA holders (where small savers were overrepresented). But this would provide no information about the effects of IRAs per se, unless there is a way to control for the observable and unobservable differences between large and small savers.

Second, recall that there are two groups for whom IRAs and saving should be very good substitutes and hence for whom IRAs are least likely to represent net additions to saving: those with large amounts of liquid assets, and those who are over 59.5 years old. Related data (not in the table) show that households with non-IRA financial assets over $20,000 or who were 59 or older made more than two-thirds of all IRA contributions in the 1983-6 period.[2] Thus, the data suggest that most contributions were made by households that would consider IRAs and other saving good substitutes, and thus that the overall effects of IRAs on saving are likely to be small at best.

Third, many analysts acknowledge the presence of a "transition period" after IRAs are introduced. The idea is that when IRAs are introduced, people will shift funds from taxable sources into IRAs so the contributions at first will not be new saving. After awhile, people will run out of funds to shift and IRA contributions will eventually become new saving. The question that is debated is: how long will this transition period last? Some IRA proponents have reasoned that since the typical household has very little in pre-existing financial assets, the transition period will be very short: a year or less.

The logic of a short transition period is misleading for two reasons. The first is simply that the typical household in 1986 did not have an IRA, so the typical household is irrelevant to the debate about how long the transition will last. The relevant households are those that contributed to IRAs and in particular those that continue to contribute to IRAs: Did these households many pre-existing assets that they could shift into IRAs. The answer here is a resounding "yes." The table shows that pre-existing asset balances are high among household with IRAs. The typical IRA household in 1986 had over $20,000 in non-IRA financial assets. Among households that contributed to the limit for three years in a row, typical financial asset balances were $40,000. It is clear that for these households, IRAs could be financed from pre-existing asset balances for several years without raising saving.

The second problem with the proponents' logic is even more important: it ignores IRA contributions that are financed by current or future saving that would have been done even in the absence of IRAs. These contributions do not represent new saving. The table shows that typical IRA households and 3-year limit contributors have extremely high levels of other saving relative to their IRA contributions and so could easily finance contributions out of saving that would have been done anyway. The median 3-year saving level for 3-year limit contributors in the SCF was $60,000. Surely, it would not be difficult for many of them simply to shift $12,000 of that into an IRA. The median 3-year saving level for the typical IRA contributor was $23,000. This is certainly large enough to fund all or most of a typical three years worth of contributions.[3] These figures suggest that among households that did contribute to IRAs, there was a large on-going source of funds from which IRA contributions could be financed without raising saving. There is every reason to think the transition period could take a very long time.

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[2]Households who had non-IRA financial assets in excess of $40,000 or where the head was 59 or older made half of all IRA contributions during this period.

[3]The typical IRA household did not contribute every year: less than 1/3 of households with IRAs contributed all five years from 1982 to 1986. Half contributed all three years from 1982-4.

Evidence on the Effects of IRAs on Saving

There are two principal types of formal studies of IRAs. One type compares IRA contributors to non-contributors. The other type compares one group of IRA contributors to another group of IRA contributors.

The earliest studies of IRAs compared the behavior of IRA contributors to that of non-contributors. These studies claimed that IRA contributions raise saving. It has become clear, though, that these studies face very difficult challenges due to the differing propensities to save across different types of households. It is thus unclear whether these studies are uncovering evidence that IRAs raise saving or merely showing that people with high propensities to save tend to save more than people with low propensities to save.

For example, the degree of substitutability between IRAs and other saving can vary across households. The households that tend to contribute to IRAs (high wealth, older) are also the ones that should find IRAs to be better substitutes for other saving, and hence their IRA contributions are less likely to be net additions to saving. The households that tend not to contribute (younger, low wealth) are the ones that should find IRAs to be poor substitutes for other saving. Thus, if these households were to contribute to IRAs, their contributions would be more likely to be net additions to saving.

When comparing the 80 percent or so of the population that did not contribute to IRAs and the 20 percent that did, it is not surprising that the tendencies of the larger group dominate the estimates. That is, the estimate of substitutability for the overall population can be thought of as essentially a weighted average of the substitutability for the different groups and hence tends to reflect the low substitutability for the 80 percent that did not contribute. But the effects of IRAs on saving depend only on whether the households that contributed to IRAs found IRAs to be good substitutes for other saving. As noted above, these households differ systematically from the rest of the population in their substitutability of IRAs and other saving. The effects of IRAs depend in no way on whether people who do not contribute find IRAs to be good substitutes for other saving. Therefore, studies that compare contributors and non-contributors may be generating estimates that apply to the wrong group.

The second type of study has compared one group of IRA contributors to another group of contributors. The great advantage of such studies is that, by comparing one type of "saver" to another type of "saver," the studies control for unobservable differences between the groups in propensity to save. One such study was a paper I wrote with John Karl Scholz. Our model compared the saving behavior of households that contributed the maximum amount and those that contributed less than the maximum. We found that increases in IRA contribution limits would have resulted almost entirely in the redirecting of saving that would have been done anyway. Our paper also showed that it is statistically invalid (at least in our model) to compare contributors and non-contributors.

In another study, Eric Engen, Scholz and I look at two matched group of savers: 401(k) contributors and IRA contributors not eligible for 401(k) plans. Because the 1986 tax reform act reduced the attractiveness of IRAs, any positive effect of 401(k) plans on saving should show up in increased assets of 401(k) contributors relative to IRA participants not eligible for 401(k) plans between 1986 and 1991, controlling for other factors. We found, however, that there was no increase in assets of the 401(k) group relative to IRA contributors not eligible for 401(k) plans. This is consistent with 401(k) plans not raising overall saving. Other work that we have done and research by other scholars has produced similar results suggesting that the expansion of the IRA program has generated little in the way of new saving.

A final type of study has looked at the wealth of different cohorts of families over recent years. The idea is that, if saving incentives are raising saving, then the wealth of a typical 55 year old in 1991 should be greater than that of a typical 55 year old in 1984, because the former will have had access to saving incentives for a longer period of time. Indeed, there does appear to be evidence that the later cohorts have higher levels of financial assets than the earlier cohorts.

But this evidence should be interpreted cautiously, because it omits numerous factors that could work in the opposite direction. First, the analysis omits debt, but contributions to saving incentives can be financed by increasing debt holdings, and the debt/income ratio rose dramatically in the 1980s. Second, contributions can be financed by choosing to invest in financial rather than non-financial assets. The analysis omits non-financial assets, but there was a shift from nonfinancial to financial assets over the decade. Third, the analysis omits pensions, although there are obvious interactions between saving incentives and pensions. During the 1980s, non-401(k) pension coverage fell. Fourth, the 1980s saw the longest peacetime expansion since at least the 1920s and experienced a dramatic rise in the stock market. These historically rare factors may have contributed importantly to the findings. Fifth, not all of IRA and 401(k) balances represent private wealth, because the household will still have pay taxes on whatever is withdrawn. The after-tax balances are probably only about 2/3-4/5 of the total. It is unclear how accounting for these factors would affect the conclusions.

Would Saving Incentives Work in the Long Run?

There is no necessary relation between the short-run and long-run effects of saving incentives. To examine the long-term effects, Engen, Scholz and I examined the effects of IRAs and 401(k) plans in a computer simulation model that tracks households' consumption, IRA saving, and non-IRA saving decisions over their lifetime.[4]

The results indicate that, following the introduction of an IRA, private saving falls and stays lower for a lengthy period. This occurs because people shift funds from taxable assets into IRAs and redirect into IRAs current and future saving that would have been done in taxable forms if IRAs had not existed. Thus, the model predicts that in the years following introduction of saving incentives, one would expect to see active participation in saving incentives and falling levels of other saving. As noted above, this is, broadly speaking, the pattern that has occurred in the U.S. since the early 1980s, and it is consistent with the reasoning above as to why the "transition period" should be thought to be lengthy.

After several years, the incentive effects of IRAs begin to dominate the shifting effects from other assets and other saving, and the private and national saving rate start rising. In the IRA example, it takes 49 years for the national wealth-to-income ratio to regain its initial value. For 401(k) plans, it takes "only" 35 years to regain the initial national wealth-to-income ratio. After 70 years, the model reaches a steady state. Ultimately, in the long run, the national saving rate is higher by 0.2-0.3 percentage points with IRAs. For 401(k) plans, the estimated effect is somewhat larger, 0.4-1.0 percentage points.

A full understanding of these results requires a number of important qualifications. First, any result projected 70 years in the future should be regarded with caution. Second, if these saving incentives are alternatively enacted and then discontinued, the model suggests that saving will actually be reduced. Given the large number of changes in tax policy in recent years, there is or should be a legitimate concern about whether a result that requires a stable tax structure for 70 years and whose benefits do not appear for at least 35 years should be pursued. So unless policymakers are certain that the policy will stay in place for a long time, the model suggests that introducing saving incentives would reduce saving. Third, for a number of technical reasons, the model overestimates the long-term effects, possibly by large amounts.[5] Fourth, the model does not include other tax-preferred, relatively illiquid assets (housing, for example) so it speaks to the effects of IRAs and 401(k)s only under special circumstances. Since the real world already has numerous tax shelters besides IRAs and 401(k)s, the real world issue is whether policymakers should add or enhance another tax shelter. The model does not address this issue.[6]

Psychological Models of Saving

The standard economic approach to analyzing the effects of saving incentives has come under attack in recent years from scholars who argue that psychological models are better at explaining how people save. These scholars argue that self-control is at the heart of the saving

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[4]See Eric M. Engen, William G. Gale, and John Karl Scholz, "Do Saving Incentives Work?," Brookings Papers on Economic Activity, 1994:1. The model includes overlapping generations of households. In the model, people save as a precaution against income risk and uncertain lifespan. The model predicts fairly accurately a number of characteristics of IRA and non-IRA saving, but overpredicts the saving and wealth of low-income households.

[5]These include: the absence of other tax-shelters, the overprediction of the participation of low-income households in the model, the absence of general equilibrium effects, the overstatement of the 401(k) limits, and the understatement of the 401(k) early withdrawal penalty.

[6]A final caveat should be added. Some proponents of IRAs have tried to recast the simulation results by looking at the ratio of the change in national saving and the change in government revenues. Use of this ratio is subject to all of the caveats above, as well as the fact that the ratio is a misleading and inconsistent indicator of the effects of the programs on saving. Specifically, a higher ratio need not imply a bigger effect on saving. It is easy to construct comparisons of policies where the ratio is higher for one policy but the effect on saving is higher for the other.

problem and that households divide their assets into different types of "mental accounts," some of which they feel are available for current spending and some of which are not. Proponents of these models suggest that IRAs serve to raise saving by giving an immediate benefit (the tax deduction) to people who would otherwise be reluctant to save and by placing the IRA funds "off-limits" in a non-liquid mental account. Other scholars have claimed that the availability of IRAs, coupled with the heavy advertising that accompanied IRAs in the 1982-6 period, can raise saving by informing people of otherwise unknown opportunities for saving, or by giving them saving targets that help convey the need to save.

These theories are intriguing, and merit further research, but their applicability to IRAs is questionable. Specifically, the applicability of these theories depends on who contributes to IRAs. If most IRA contributors had low wealth, then the theories would be more likely to be relevant. However, as noted above, the typical IRA contributor has seven times the non-IRA financial assets, four times the overall net worth, and eight times the saving of the typical household without IRAs. It thus seems clear that the typical IRA household does not need to have special incentives in order to save, and is aware of the opportunities for and need for saving. Moreover, households that are unable to accumulate much in conventional assets, as evidenced by low wealth totals, also tend not to contribute to IRAs. One of the key facts from the 1982-6 "experiment" with IRAs is that low wealth, low income, and young households had very low participation rates.

Raising the Saving rate

Since I believe that raising the saving rate is important, but that enhancing current saving incentives is unlikely to work, it is fair to ask what I would propose instead. First, I would suggest reduced expectations. There is no painless, quick fix for the saving decline. The decline in private saving has occurred over a number of years, and for a variety of reasons. To the extent that the decline is related to the liberalization of credit markets, increased transfers to the elderly, and the decline in wage and income growth, it will be difficult to alter the course of private saving through minor changes in the tax system. Second, the surest way to raise national saving is to reduce the deficit and in particular to reduce it in ways that raise or at least do not reduce private saving. A number of changes to the Social Security system, such as raising the retirement age faster and farther than is currently planned, would work in the right direction.

Third, if we are to raise the private saving rate, it will most likely be through expanding, enhancing, and simplifying the nation's pension system. Pensions differ from saving incentives in that pension participation is less optional, given one's job, and pension balances are less liquid pre-retirement. For these reasons, pensions may provide stronger effects on saving than elective saving incentives. Policy could usefully be directed toward re-examining the overfunding rules and the non-discrimination rules, and seeking ways to enhance pension coverage, especially among low-income workers. Note that these workers currently have access to fully deductible IRAs but do not tend to use them.

Finally, many American workers may be unaware of the need to save for retirement. Some sort of realistic education program may prove useful in raising the saving rate, but is certainly not a panacea.

Mr. THOMAS. Thank you, Mr. Gale.
Mr. Feltman.

STATEMENT OF KENNETH E. FELTMAN, EXECUTIVE DIRECTOR, EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION, WASHINGTON, D.C.

Mr. FELTMAN. Thank you, Mr. Chairman and members of the committee. The Employers Council represents over 800 employers of virtually all sizes and types and they employ over 14 million working Americans. The council supports the concepts behind the American dream savings account because it is one step toward solving the pending crisis in savings.

For too long, our Tax Code has discouraged savings, and when government creates a bias against savings, none of us should be surprised when people do not save. Passage of incentives will send a signal to all Americans that they must start now to save for their own future well-being. We are pleased that the debate seems to be over the structuring of the incentives; not over whether they are needed. Our recent research shows that incentives are needed.

For example, despite signs of an improving economy, the amount workers are saving for retirement dropped 8 percent in 1994 over 1993, and 34 percent over the past 2 years, according to our new National Workplace Pulse Survey of full-time working Americans. The survey was conducted in November 1994.

Workers expect individual savings to account for more than one-third of their retirement income, and most recognize that they are not setting aside enough to meet their retirement needs. Last year, for example, workers saved an average of only $1,776 annually for their retirement needs. That is compared with $1,932 the year before, and $2,688 in 1991, again according to the survey.

One factor contributing to the decline in retirement savings may be inadequate government incentives. Again, according to the survey, 82 percent of the workers who responded said that tax incentives are inadequate to encourage the average working person to save for retirement. Our research has found a widening gap between what workers believe they will need and get at retirement and what they are actually going to receive. I call this the expectations gap.

Our survey suggests that most workers know they are in trouble, but they are unable to do much about it. It is a cause of anxiety for them, but it is also good news because it suggests that these workers will save more if given incentives. Most people, 66 percent—that is an increase from 60 percent in the prior year—recognize that they are saving too little for their own retirement. They recognize that they, not their employers, not the government, will have to come up with the bulk of their retirement income.

I repeat—workers believe the government could be doing a lot more to help them; 82 percent, an overwhelming majority, tell us that government tax incentives are inadequate to encourage people to save for retirement. For people in their forties and their fifties, time is running out. If they have not salted something away, they need to start now and do so aggressively. No one can step in and help them in time to make much of a difference.

Unless they expect to win the lottery or die young, they are facing a rather bleak old age. They might not be able to afford needed medical or long-term care. These findings suggest that the system itself is simply not working.

Families cannot do it alone. They have too many other priorities, too many other bills to pay. They need help from employers and from the government. But not in the form of new entitlements; rather new incentives to save for retirement.

I believe that Workplace Pulse is sending Congress and all of us a clear message, and just in time. Workers and employers will respond if they are given a reason to save and an incentive to save. People now seem to recognize the reason, but they need your help. That is exactly where Congress should come in. Congress must act before time runs out for an entire generation.

Thank you.

[The prepared statement follows:]

Statement of Kenneth E. Feltman
Executive Director
Employers Council on Flexible Compensation
Before the
Committee on Ways and Means
House of Representatives
January 31, 1995

Introduction
Thank you Mr. Chairman and Members of the Committee. My name is Kenneth E. Feltman and I am executive director of the Employers Council on Flexible Compensation, a non-profit membership association committed to the study and promotion of 401(k) plans, cafeteria medical plans, and other elective compensation plans. The more than 800 members of ECFC are plan sponsors, corporations, governments, unions, universities, hospitals and clinics who are leading the way in the development and refinement of flexibility in benefit plans and the leading actuarial, insurance and accounting firms that design and administer flexible plans.

The Council supports the concepts behind the American Dream Savings Account because it is one step toward solving the pending crisis in savings. For too long, our tax code has discouraged savings. Just as individuals will reap what they sow and will find that when they have not saved enough they will suffer, so does the Government reap what it sows. When Government creates a bias in the tax code against savings, we should not be surprised when people do not save.

The Council favors incentives that will encourage workers and their employers to save to prepare for medical and long-term care needs in retirement. Passage of incentives now will send a signal to all Americans that they must start now to save for their own future well being.

We are pleased that the debate seems to be over the structuring of the savings incentives, not over whether they are needed. Our recent research shows that incentives are needed.

Since 1990, ECFC has co-sponsored Workplace Pulse, a national survey of 1,000 American workers that measures attitudes toward employee benefits and related issues. Unlike most national opinion surveys, Workplace Pulse interviews only Americans who are employed and work a minimum of 30 hours weekly -- no retirees, unemployed or part-timers. Otherwise, the survey population is a statistical profile of the national population in terms of race, gender, age, political affiliation, region and income level. The survey is directed by Dr. Verne Kennedy, senior research analyst for Pulse Surveys of America, and president of the Marketing Research Institute.

I am pleased to have the opportunity to share with the Committee the findings of the most recent Workplace Pulse survey on retirement, conducted last November. We believe that Workplace Pulse has brought into focus some issues that are cause for real concern as the Committee reviews federal tax policies, entitlements and other issues related to retirement.

Survey Background
Since 1991, we have been particularly interested in tracking workers' attitudes toward retirement and retirement savings. We recognize that decisions made by workers themselves today are the single most important factor determining the financial security of tomorrow's retired generation. After three years of attitudinal tracking, we believe

that we have developed a valuable measure of the financial security of the coming generation of retired Americans.

Of the three traditional sources of retirement income -- employer plans, social security and individual savings -- individual savings today is by far the most important. Today's workers have more responsibility to plan and save for their post-retirement income than did the generation in retirement now. Fewer workers can plan on income from defined benefit pension plans and, in general, employer contributions to retirement plans have declined. With the popularity of 401(k) plans and other flexible plans, workers have greater control over their retirement plans. With greater control comes greater responsibility.

Retirement Savings

Our 1993 Workplace Pulse survey suggested we are quickly approaching a crisis in retirement income expectations; we found a widening gap between what workers believe they will need and get at retirement and what they will actually receive. In our most recent survey, we were particularly interested in finding out more about this gap in retirement expectations -- which I call the "expectations gap."

I regret that our November survey shows things are continuing to get worse, not better. Americans are saving even less toward retirement now than they were a year ago, despite signs of an improving economy. Yet people expect to retire at the same time as their parents, they want to retire comfortably and they recognize that they -- not their employers or the government -- will have to provide the bulk of their retirement income.

In October 1992, when we conducted our first Workplace Pulse survey on retirement issues, we found that two-out-of-three workers recognize that they are setting aside too little themselves for retirement -- an average of $223 per month or $2,688 annually. In November 1993, we again asked workers how much they were saving toward retirement and our sample said they were saving an average of only $161 monthly toward retirement, or about $2,000 a year, a decrease of 28 percent from 1992. In November 1994, we found that individual retirement savings dropped again, to $148 monthly, or about $1,776 annually -- a 34 percent decline in just two years at a time when individuals must provide more, not less, of their retirement income. The only good news is that the rate of decline lessened year-to-year, to about 8 percent.

As you might expect, as workers age they save more for retirement. Our survey found that workers over 45 years old have actually increased their savings rate over last year, from an average of $2,408 annually to $2,700, which was about the national average for all age groups two years ago. However, our survey found that workers under 45 are saving significantly less than the national average. Workers under 35 are saving only $1,308 annually.

It is clear that millions of working Americans simply will not be able to retire in financial security unless they are able to change their savings habits dramatically. If current trends continue, the baby boom generation may end up working into their 70s to make ends meet or relying upon their families, welfare, or charity to survive.

Workers' Expectations

Our survey suggests that most workers know they are in trouble, but are unable to do much about it. That is a cause of anxiety for them, but is also good news because it suggest that these workers will save more if given incentives.

Most people -- 66 percent, an increase of six percentage points over last year -- recognize that they are saving too little for retirement. They also recognize that they, and not their employers or social security, will have to come up with the bulk of their retirement income.

Despite this knowledge that their current savings rate will not allow them to retire comfortably, people have not changed their retirement expectations accordingly. This is the "expectations gap."

Despite the national trend towards working later in life, most working Americans say they plan to retire before age 65. The typical respondent plans to retire at age 61. Twenty-nine percent of our sample expects to retire before the age of 60. Our findings on planned retirement age have not changed from last year.

In addition to retiring early, workers do not plan to lower their standard of living when they retire. Seventy percent said they plan to live as well or better than when earning a full salary.

Retirement Planning
Even if they cannot afford to save much now, are workers at least planning for retirement?

Unfortunately not, according to Workplace Pulse. Only 7 percent have completed a retirement financial plan. Nearly one out of four, 23 percent, has yet to start planning and 44 percent say they have only started planning. Though they clearly are not following their own advice, our sample said individuals should begin planning early for retirement, at the age of 25.

Employer and Government Roles
Workers may take some solace in the fact that their employers seem to be doing slightly better in providing retirement support than they were a year ago. Seventy-eight percent reported that their employers provide some sort of retirement or pension plan, up from 71 percent last year. Yet only about 64 percent of our total sample is participating in employer-provided plans, an increase from 58 percent in 1993.

By overwhelming numbers, workers prefer the flexibility and choice provided by 401(k) plans. More than 50 percent want their employers to offer a 401(k). That is a significant increase from 1992, when 401(k) plans were the most popular retirement plan with 41 percent of the sample.

Workers believe the government could be doing a lot more to help them. An overwhelming majority -- 82 percent -- said government tax incentives are inadequate to encourage people to save for retirement.

Long-Term Care
Perhaps no other retirement costs have risen as much as medical care and long-term care. We asked several new questions about long-term care this year, and found some of the same attitudinal disconnect that we found on other retirement issues. Nine-out-of-ten workers want to receive long-term care at home, not in an institution, despite the lack of affordable home health care in many communities. More than half, 52 percent, said that is not likely that they will ever need long-term care, but statistics and projections indicate many more will.

Those who do plan on needing long-term care look toward private insurance or their own savings to pay for it. Relatively few expect the government or their employers to help, and only 16 percent believe their families will take care of them. However, only one-in-eight workers -- 16 percent -- has actually purchased a long-term care policy. Sixty-three percent say they would be more likely to buy long-term care coverage if it were offered through a payroll deduction at a reasonable cost.

Summary
These Workplace Pulse findings give us a better understanding of what is going on and raise several serious policy questions. The new Congress and the Administration must come to grips with the fact that we cannot rely on the economy alone to provide

today's workers with an adequate retirement. The average family just cannot make it alone in this economy. If steps are not taken now, we face a pending social crisis when millions of retiring baby boomers discover that they cannot retire in the lifestyle they expected or when they expected.

Individual workers can no longer look to others for help. Their retirement destinies are in their own hands, and our survey suggests that people are slowly coming to grips with this new retirement reality. They know they are not saving enough. They know they are not planning for retirement. They want a retirement as good as their parents have had, but they're discovering that they just cannot save enough without help.

Should the economy continue to improve, will workers be able to afford to save more? Or will it take an even bigger boost in the economy to turn around this trend? We will not know for sure until future Workplace Pulse surveys, but these results do deliver some sobering messages.

First, it is clear that for people in their 40s and 50s, time is running out. If they have not salted something away, they need to start now and do so aggressively. No one is going to step in and help them in time to make a difference. Unless they expect to win the lottery or die young, they are facing a bleak old age where they will not be able to afford medical or long-term care.

Second, these findings suggest that the system itself is simply not working. Families simply cannot do it alone. They need help from employers and from the government, not in the form of new entitlements, but rather new incentives to save for retirement.

At the same time that many employers have reduced their retirement plans and more responsibility for retirement income has been placed on the worker, the government has quietly made it much more difficult for employers and employees to save. Even the GATT legislation passed last year chipped away at individuals' ability to save for retirement.

We have witnessed the whittling away of the amount individuals can save in tax-favored individual retirement accounts. Non-discrimination rules make it more and more difficult for middle income workers to contribute significantly to their own tax-deferred 401(k) plans. Federal regulations are strangling defined benefit pension plans. It is no wonder that only 14 percent of workers surveyed said that tax incentives are adequate to encourage the average working person to save for retirement.

Acting now to develop and implement a comprehensive national retirement income policy that encourages rather than discourages individual retirement savings is more than good politics. It is also good government. Every retirement dollar salted away today will save the government more dollars years later in health care, welfare and other social programs. As they say in the advertisement, you can pay a little now...or you can pay a lot more later.

I believe this Workplace Pulse survey is sending Congress a clear message just in time. Workers and employers will respond if they are given a reason to save and an incentive to save. People seem to recognize the reason, but they need help. That is exactly where Congress should come in. Congress must act...before time runs out for an entire generation.

Thank you.

Mr. THOMAS. Thank you very much.
Ms. Mohr.

STATEMENT OF MARY L. MOHR, CHAIRPERSON, SAVINGS COALITION OF AMERICA, WASHINGTON, D.C., AND SENIOR VICE PRESIDENT, FIRST TRUST CORP., DENVER, COLO.

Ms. MOHR. Good morning, Mr. Chairman and members of the committee. My name is Mary Mohr. I am senior vice president of First Trust in Denver. First Trust is the country's largest independent trust company. I am also chair of the Savings Coalition of America and am representing them today.

The Savings Coalition includes 50 members, representing a wide variety of interests, including consumer, health care, education and business groups, engineers, homebuilders, realtors, trust companies, banks, and brokerage firms. The coalition would like to thank the committee for holding these hearings and for the invitation to testify in support of the American Dream Restoration Act.

On behalf of the coalition, I want to commend you for your leadership and vision demonstrated in your efforts to restore tax incentives for saving to all Americans.

The Savings Coalition of America was established in 1991 to support incentives to increase personal savings rates. It has as its primary objective to encourage congressional and administrative approval of expanded IRA legislation. The coalition is committed to seeking the enactment of expanded retirement account legislation and supports the key features of H.R. 6, the American Dream Restoration Act.

The coalition believes that tax and economic policy should provide more opportunity and incentive for Americans to save and invest for the future. By restoring the American dream of owning a home, sending children to college and retiring comfortably, the ADS account will respond to many of the concerns that members of the middle class express today. The Savings Coalition of America supports H.R. 6, the Thomas-Neal bill and S. 12, the Roth-Breaux bill in the Senate.

U.S. savings rates are now lower than during any comparable period in American history. According to the CBO, personal savings rates have decreased steadily over the past 25 years, falling from 8 percent in the sixties and seventies, to less than 4 percent today. The causes and consequences of saving rate declines has been the subject of considerable debate among economists and policymakers, but the policy solutions were best articulated to Congress 24 years ago by President Nixon in the following quote:

> Self-reliance, prudence and independence are qualities which our government should work to encourage among our people. These are also qualities which are involved when a person chooses to invest in a retirement savings plan, setting aside money today so that he will have a greater security tomorrow. In this respect, pension plans are a direct expression of some of the best elements in the American character. Public policy should be designed to reward and reinforce these qualities.

The IRA best exemplified these qualities by empowering American taxpayers to take control of their long-term finances, placing responsibility for their retirement squarely on their own shoulders. But after the Tax Reform Act of 1986, Americans watched opportunities to increase their IRA nest egg slip away.

Why? Many working Americans who made tax-deductible contributions to IRAs for 5 years, stopped saving in an IRA because the front-end deductibility, the primary incentive, was taken away with the Tax Reform Act. Financial companies and banks stopped advertising, and savings rates plummeted. Without tax incentives, many Americans found they could not afford to save.

The ADS addresses these obstacles by empowering the middle class to provide for themselves and their families in the future, enabling retiring Americans, who are living, on average, 16.7 years beyond the age of 65, to accumulate additional sources of retirement income; by assisting Americans who have come to realize that Social Security and private pensions combined, provide only 45 percent of the average married person's retirement income; by offering incentives to save in the event of major catastrophic illnesses or long-term care expenses not covered by health insurance, creating the opportunity for all Americans, parents, children and grandchildren to achieve the highest level of education that they would like to attain; by encouraging those Americans who have dreamed of owning a first home but were previously shut out of the housing market, an opportunity to save for a downpayment; and finally, supporting families with one income by recognizing the equal value of work performed in the home.

The Savings Coalition also supports the Thomas-Neal bill which provides savers with two options, by restoring the traditional benefits to all savers as well as providing the back-ended IRA feature. Like H.R. 6, this proposal allows for penalty-free withdrawals in the event of major life events. Both the ADS accounts and the proposed IRA will offer benefits for which most Americans are not currently eligible.

By offering a tax incentive that is universally available to all savers, and that includes the flexibility to accommodate major life events, the ADS account and the IRA are indeed solutions for the nineties. The Savings Coalition of America looks forward to working with the committee and would like to take this opportunity to extend an offer of assistance.

Our members are committed to pursuing the enactment of expanded retirement account legislation and believe that with your leadership, Americans will once again have the opportunity and incentive to save and invest for the future.

Thank you very much, Mr. Chairman.

[The prepared statement and attachments follow:]

TESTIMONY OF MARY L. MOHR
ON BEHALF OF THE
SAVINGS COALITION OF AMERICA
1225 I STREET, NW, SUITE 500
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BEFORE THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING H.R. 6
THE AMERICAN DREAM RESTORATION ACT
JANUARY 31, 1995

Introduction

Good morning, Mr. Chairman and Members of the Committee. My name is Mary Mohr. I am Senior Vice President of First Trust Corporation of Denver, Colorado. First Trust is the country's largest independent trust company, specializing in self-directed retirement plans. I am also Chair of the Savings Coalition of America and am representing the Coalition here today. The Savings Coalition includes 50 members representing a wide variety of interests, including consumer, health care, education and business groups, engineers, home-builders, realtors, trust companies, banks, security firms and financial service companies.

The Coalition would like to thank the Committee for holding these hearings and for the invitation to testify in support of the American Dream Restoration Act. On behalf of the Coalition, I want to commend you for the leadership and vision demonstrated in your efforts to restore tax incentives for saving to all Americans.

The Savings Coalition of America was established in 1991 to support incentives to increase personal saving rates. It has as its primary objective:

> To encourage Congressional and Administrative approval of expanded IRA legislation.

The Coalition is committed to seeking the enactment of expanded retirement account legislation and supports the key features of H.R. 6 - The American Dream Restoration Act. The Coalition believes that tax and economic policy should provide more opportunity and incentive for Americans to save and invest for the future. By restoring the American dream of owning a home, sending children to college and retiring comfortably, the ADS account will respond to many of the concerns that members of the middle class express today. The reasons for supporting this proposal are compelling and reasonable. The Savings Coalition of America also supports the Thomas-Neal bill and S-12, the Roth/Breaux bill in the Senate. We look forward to working with both houses to pursue expanded retirement savings legislation.

Self-Reliance, Prudence and Independence

United States saving rates are now lower than during any comparable period in American history. According to the Congressional Budget Office, personal saving rates have decreased steadily over the past 25 years, falling from 8% in the 1960s and 70s to less than 4% today. The causes and consequences of saving rate declines have been the subject of considerable debate among economists and policy-makers, but the policy solutions were best articulated to Congress more than 24 years ago:

"Self-reliance, prudence, and independence are qualities which our government should work to encourage among our people. These are also qualities which are involved when a person chooses to invest in a retirement savings plan, setting aside money today so that he will have a greater security tomorrow. In this respect pension plans are a direct expression of some of the best elements in the American character. Public policy should be designed to reward and reinforce these qualities." President Richard Nixon, December 9, 1971 *(Schultz, 1994, p.224)*.

It was with this vision that Individual Retirement Accounts ("IRA") legislation was first introduced. By emphasizing the values of self-reliance, prudence and independence, the IRA was designed to empower American taxpayers to take control of their long-term finances and to place ultimate responsibility for their retirements squarely on their own shoulders.

Enacted in 1974 and liberalized in 1981, the IRA tax incentive allowed every U.S. worker to save and invest up to $2,000 in earnings annually in his or her own personal pension plan. During the IRA's most popular period, from 1982 to 1986, American workers contributed more than $172 billion to IRAs **(Table 1)** *(IRA Reporter, August 1994)*. Increasingly, Americans became aware of the importance of long-term saving and recognized that for many of them, the IRA represented their best opportunity to accumulate retirement funds.

Joseph Nocera cites the IRA as "the financial device that brought home the realization that the American middle class was going to have to take control of its own financial future" *(Nocera, 1994, p.288)*. Among the American middle class, the success of the IRA precipitated what has been described as a major cultural shift. Before the IRA, many middle class Americans felt powerless to control their long-term finances and, although they might save at their local bank or thrift, few had experience as investors. The IRA industry not only helped the middle class to assume a role in securing a more comfortable retirement, but also offered opportunities to expand their understanding of and participation in financial markets.

But when the Tax Reform Act of 1986 ("TRA") sharply curtailed IRA eligibility by excluding taxpayers with incomes over $50,000 (or $35,000 for single taxpayers) who participated in a pension plan at work, it caused a dramatic decline in annual IRA contributions. According to the Internal Revenue Service, contributions fell from an annual average of $34.5 billion during 1982 to 1986, to an annual average of $11.9 billion from 1987 through 1993 **(Table 1)** *(IRA Reporter)*.

Not only did the number of IRA participants decline, but more importantly, many of those working Americans who once considered the IRA as "the people's nest egg" *(Nocera, p.289)*, now found that they no longer had their government's support and encouragement to establish long-term savings.

Fewer Incentives, More Obstacles to Saving

By 1986, Americans watched opportunities to increase their "nest egg" slip away just as quickly as the IRA had been embraced as the solution to saving rate declines. Without tax incentives, many Americans found they could not afford to save. In addition, workers increasingly encountered economic, social and demographic obstacles to maintaining or improving their financial existence. Consider the environment in which middle class families are trying to achieve the American Dream.

<u>Economic Uncertainty</u>

Having experienced job layoffs and economic stagnation throughout the last decade, members of the American middle class continue to feel uncertain about their ability to provide for themselves and their families in the future.

Aging Population, Longer Retirement

The retirement period has lengthened, requiring more financial support. In 1960, Americans aged 65 and over made up 9% of the population. By 1990, this proportion reached 13%. It is expected to reach 18% by 2020 and 23% by 2050. Retirees reaching age 65 can expect to live, on average, another 16.7 years. A longer retirement period results in "an increasing portion of Americans who will have to depend on sources other than employment for income and vital services" *(Employee Benefit Research Institute, 1992, p.8).*

Social Security Cutbacks

The Social Security Old-Age and Survivors Insurance ("OASI") program can no longer be depended upon as a primary source of support throughout retirement. Currently, Social Security and private pensions combined provide only 45% of the average married person's retirement income. Yet, Money magazine (June 1991) found that its readers consistently overestimated the amount they will receive from Social Security and their pension funds, and underestimated how much they will need to save for retirement. In addition, existing law will soon begin to push back the current retirement age when Americans can receive full Social Security benefits. These cutbacks will apply to and increase for all workers born after 1937 in anticipation of the disproportionately large number of baby-boomers who will soon be entering retirement *(EBRI, 1992).*

Underfunded Private Pensions

Reports of the Pension Benefit Guaranty Corp. ("PBGC") taking over the underfunded pension plans of well-known, financially-troubled corporations, have sparked alarm among many workers who are depending on their employer's pension plans to provide a major portion of their retirement income. The PBGC indicates that pension plan underfunding is a problem that will continue to pose risks for many retirees *(Wall Street Journal, February 4, 1993, p.1).*

Rising Health Care Costs

The aging population and the rapid upward pace of health care costs are having a tremendous impact on medical expenses. Between 1970 and 1990, the price level of medical services and commodities rose 479%, compared with a 337% increase in consumer prices. Even with health care benefit programs, these rising health care costs make it very difficult for working Americans to financially recover from major catastrophic illnesses *(EBRI).*

Dependent Parents

Today, approximately 60% of the elderly are dependent on their children for support. The proportion of health costs associated with nursing home care and other long-term care will increase as Americans get older. According to the Employee Benefit Research Institute, Medicaid financed up to 43% of the $48 billion U.S. nursing home tab in 1989. But, in the absence of private insurance coverage for long-term care, consumers paid out-of-pocket expenses of approximately 45%.

Higher Education Expenses

The value of a college education has become increasingly important since the early 1970s. The difference between the earnings of a man with a high school diploma and one with a college degree was 39% in 1970 and had grown to 64% by 1988 (Byron, 1991). American parents recognize the importance of higher education, as well as the need to save for college, but few have the resources to do so. This is supported by a Roper Poll commissioned by the National Institute of Independent Colleges and Universities (1991) that showed that only half of the parents who expect their children to attend college save anything at all for future college expenses. Those who do save average only $517 per year. With the average cost of a year of college ranging from $10,000 to $25,000 today, what will Congress do to help aging baby boomers pay for their children's college education?

Housing Affordability

Since the 1980s, Americans have demonstrated declining rates of home ownership, particularly among those in the 25- to 34-year-old-age range. Payments on a typical home in the 1950s represented about 14% of an average 30-year-old's gross income. Today, a median priced home claims about 44% of income *(Burton, Dittmer, Loveless, 1992, p.154)*. Young families have also been squeezed out of the housing market because of their inability to save for a down payment. As housing prices have escalated, down payments of 10% to 20% have become out of reach for the average young American family. Providing opportunities for home ownership not only extends the American dream to more young families, but also pumps millions of dollars into the national economy through new housing starts and increased employment. Job creation then extends to the plumbers, electricians, real estate salespersons and all those working Americans participating in the housing industry.

Family Financial Pressures

Economic forces have made it nearly impossible to raise a family on one income and those families that attempt to must do so without much help from government policy. Under current rules governing IRAs, married couples are limited to a deductible contribution of $2,250 per year if only one person earns income. But, when both spouses work outside the home, each is permitted to contribute up to $2,000, for a total of up to $4,000 annually in an IRA *(Brennan, 1994)*.

The American middle class is experiencing a period of unprecedented uncertainty. For the first time in American history, parents cannot assume that their children's lives will be economically better off than their own. Without a consistent, comfortable standard of living, families are unsure how they will be able to:

- Become homeowners
- Send their children to college
- Support their aging parents
- Support themselves in retirement

Saving rates have declined, and so has the opportunity to achieve the American dream of a better tomorrow.

The American Dream Savings Account and the Individual Retirement Account - The Solution for the 1990s

The proposed American Dream Savings ("ADS") account, like the IRA, is designed to respond to citizens' concerns about the future. By offering tax incentives and empowering workers to accept responsibility, the ADS account provides hope, as well as a means to achieve long-term financial goals.

The Savings Coalition also supports the Thomas-Neal bill, which provides savers with two options, by restoring the traditional benefits to all savers, as well as providing the "back-loaded" IRA feature. Like H.R. 6, this proposal allows for penalty-free withdrawals, in the event of major life events.

Both the ADS account and the proposed IRA will offer benefits for which most Americans are not currently eligible.. By offering a tax incentive that is universally available to all savers and that includes the flexibility to accommodate major life events, the ADS account and the IRA are indeed solutions for the 1990s. The ADS account and IRA incorporate the original values of self-reliance, prudence and independence, while addressing present day concerns. With their approval, the American public's faith in the future and their resolve to achieve their own financial dreams, will be restored.

The Savings Coalition of America Supports the ADS Account

The Savings Coalition of American looks forward to working with the Committee on Ways and Means, and would like to take this opportunity to extend an offer of assistance on any issues related to the legislation. Our members are committed to pursuing the enactment of expanded retirement account legislation and believe that with your leadership, Americans will once again have the opportunity and incentive to save and invest for their future.

TOTAL IRA CONTRIBUTIONS

Historical View

Source: IRA Reporter, August 1994

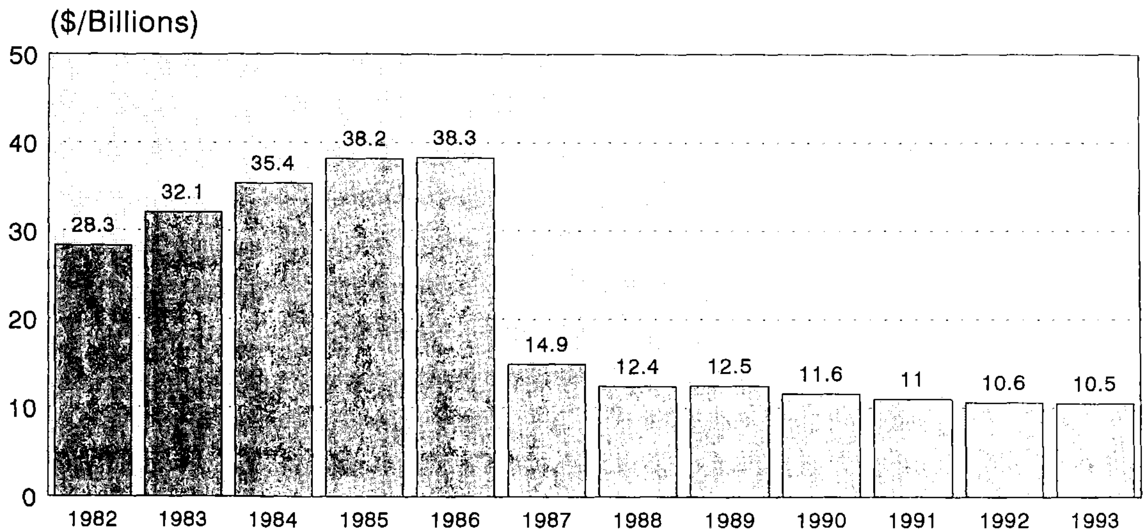

TABLE I

AVERAGE IRA CONTRIBUTIONS

Before and After Tax Reform Act of 1986

Source: IRA Reporter, August 1994

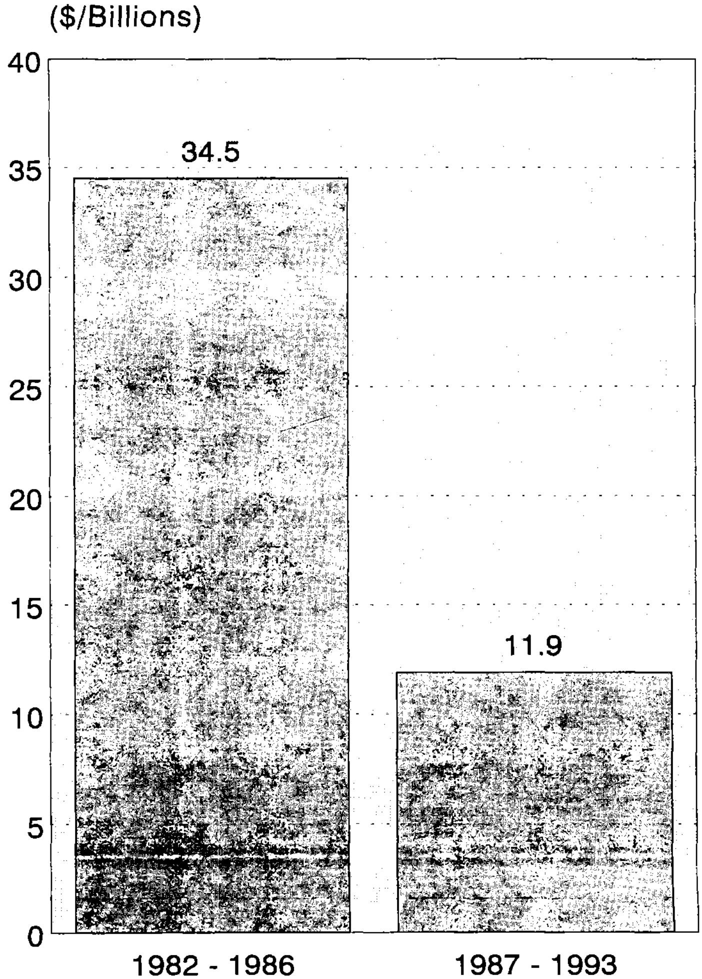

TABLE II

SAVINGS COALITION OF AMERICA

MEMBER LIST

JANUARY 1995

A. G. Edwards, Inc.
American Bankers Association
American Council for Capital Formation
American Council on Education
American League of Financial Institutions
Association of Jesuit Colleges and Universities
The Bankers Roundtable
Chase Manhattan Bank
Citicorp/Citibank
Citizens for a Sound Economy
College Savings Bank
Consumer Bankers Association
Dean Witter, Discover & Co.
Delaware Charter Guarantee & Trust Company
Edward D. Jones & Company
Fidelity Investments
First Trust Corporation
G. E. Capital
Gold & Silver Institute
HD Vest Financial Services
Household International
Independent Insurance Agents of America
Institute for Research on the Economics of Taxation
Institute of Electrical & Electronics Engineers - United States Activities
International Association for Financial Planning
Investment Company Institute
Kemper Corporation
Lincoln Trust Company
Merrill Lynch & Co., Inc.
Mortgage Bankers Association of America
National Association of Federal Credit Unions
National Association of Home Builders
National Association of Independent Colleges and Universities
National Association of Realtors
National Association of Securities Dealers, Inc.
National Association of Uniformed Services
National Rural Electric Cooperative Association
Prudential Securities, Inc.
Resources Trust Company
Retirement Accounts, Inc.
Retirement Industry Trust Association
Savers & Investors League
Saving & Community Bankers of America
Securities Industry Association
Sterling Trust Company
Transcorp Pension
United States Chamber of Commerce
Wheat First Butcher Singer

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Mr. THOMAS. Thank you very much. And I thank all the panelists.

The gentleman from Illinois.

Mr. CRANE. Mr. Steffens, you indicated that your study showed that the back-ended IRA would be very popular with the American people. I was wondering if that study embraced the broad spectrum of income groups, low, middle, upper, or whether it was targeted to a narrower range of income groups?

Mr. STEFFENS. It included a broad range of income groups. The sample size was somewhat limited because we felt that to have it done effectively, we had to conduct one-on-one education because many peoples' initial response was that they clearly would prefer the up front deduction.

Once respondents in our study began to understand the benefits of what would happen if they chose a back-ended IRA, that they would never have to pay taxes, we found that 53 percent would choose to invest in a back-end IRA.

I also think that it is interesting to note that of the remainder, the largest number were concerned that the government would come back after the fact and change the rules; that is, decide to tax savings. That was the primary reason for those that said that they would just as soon get the tax break up front.

Mr. CRANE. Mr. Feltman, did your study embrace a similar range of all income groups and reach the same conclusions?

Mr. FELTMAN. Yes, it did, and we did reach virtually the same conclusions.

Mr. CRANE. Thank you.

No further questions.

Mr. THOMAS. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

I think the economic record is clear that we have to provide for incentives for people to save and we have to have more capital available if America is going to maintain its competitive edge. Equally as important, of course, is the deficit, and we have been making such progress on that every year for the last 3 years, and this entire Contract as presented to us, at least by the estimates of the U.S. Treasury, will cost us over $700 billion over a 10-year period. And there is no question that, one way or the other, whether it is capital gains or IRAs, that we have to build up savings in this country.

But have any of you really considered the impact of what would happen if we did have a hemorrhage on the deficit, based on an extraordinarily novel way of scoring the losses of some of these tax provisions?

Ms. Mohr.

Ms. MOHR. Well, our coalition focuses on the positive. Our belief is that once Americans are given the opportunity and the incentive to save more dollars and that government supports a long-term program such as the IRA, that Americans will create more savings opportunities. Those investment dollars will create jobs in the economy——

Mr. RANGEL. I agree with you 100 percent, the same way I agree that if you invest in education, you will get a more productive worker. We need the investment and it would encourage and would leverage more investment, and we could have better plant, equipment and better competition; but if these Treasury figures are right, if we are talking about a $700 billion loss after we have now attempted to decrease our deficit, is that not even a factor?

Ms. MOHR. Well, certainly the need to decrease the deficit is obvious to all Americans.

Mr. RANGEL. If these figures are right, is there a balance here? You see, it is my impression that the majority, having the votes and the commitment to the Contract, will just give us one package, and it is up or down. This is a provision that you know is not that expensive, $17 billion over a 10-year period, as compared to $700 billion to get this turkey off the ground. But what do we do?

Is there anyone that has any concern to at least say this is a great provision, we have to provide incentives to get more people to save, but for God's sake, don't raise the deficit. Does anyone think that, or is this provision so important that you think we have to pass this and anything that the majority would say should be included?

I assume all of you read the Contract—do all of you support the Contract, the tax provisions?

Mr. HAZEN. I would have no reason to disagree with your figures as far as the amount of money lost over a 10-year period to the government, but I feel that there would be some savings to subtract from your figures in regard to the number of Americans who would be able to care for themselves in this area, as opposed to the government having to spend moneys to help them in this regard.

Mr. RANGEL. Mr. Hazen, when you reduce the deficit, I don't know what it is like now, but close to one-third of every one of our tax dollars, especially you as a voter and taxpayer, goes to pay the interest on our debt. So if we were really able to get down to a zero deficit, all of us get tax benefits from it because it is a lesser liability.

My point is that if all the economists are convinced, except the ones that they will be able to bring in here, that this is a revenue loser, a substantial revenue loser, should we as lawmakers consider that?

Mr. STEFFENS. Many have not looked at the IRA issue in a dynamic way. The macroeconomic models that we have looked at say that within a 10-year period, the Federal Government could look to save around $25 billion a year in interest, more than offsetting the cost of the IRA program because of the additional supply of savings.

In fact, examining the lost savings from the reduction in IRAs since 1986, you could build a very strong case that that has cost $25 to $40 billion a year for the last 8 or 9 years, plus the interest on that, we would have had an additional $400 billion pool that would have been available to make investments in the U.S. economy.

Mr. RANGEL. I didn't make my question clear. I support the IRA, but as part of a much larger tax package.

Mr. THOMAS. The gentleman's time has expired.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Just to try to give a brief response to Mr. Rangel; you may be interested in a quote from Martin and Kathleen Feldstein regarding the American dream savings account which is a substantial portion of the tax provisions of the Contract. We are sold on the new American dream savings account as an attractive way to encourage saving. We are also convinced from studies of the experience with traditional IRAs, that such accounts do raise the national saving rate, even if the loss of tax revenue causes the budget deficit to rise.

So there are two noted economists who think the value of such a broad savings instrument for the American people outweighs even some loss of revenues to the Federal Government.

Mr. RANGEL. Would the gentleman yield?

Obviously, I did not word my question to Mr. Steffens as clearly as I would like, but is it possible that I can support this IRA provision in this committee and not have it a part of a bigger package? I thought that this was a part of the Contract, not just a paragraph.

Mr. MCCRERY. It is part of the Contract and we look forward to having your support for it. If you would like to try to separate it, you can do that later on as we go through this.

Mr. RANGEL. I was under the impression, and this may help all the Members, majority and minority, that when this turkey is cooked, we have to vote up or down, that we won't be able to splice off the parts that we like.

Mr. MCCRERY. That is the way we would prefer it and that is probably the way we will vote.

Mr. RANGEL. This may be a good provision for the IRAs.

Mr. MCCRERY. We appreciate your endorsement.

Now, I will get back to my questioning of the witnesses.

Mr. RANGEL. All right. Thank you for your consideration.

Mr. MCCRERY. Sure.

Mr. Gale, I guess you don't agree with the Feldstein's analysis there, based on your testimony.

Mr. GALE. That is right.

Mr. MCCRERY. What about Mr. Steffens' comment, which struck me as making a lot of sense, just plain old common sense. I am not an economist and not a finance major; I am just a country lawyer, but sometimes something that somebody says just kind of makes sense to me.

Mr. Steffens said that if you create opportunities for Americans to save, easy opportunities like IRAs, things that everybody can understand, it creates a culture of saving, and he thought that was important to create that culture of saving in the American society. Do you put any credence in that at all?

Mr. GALE. I think if we could create a culture of saving that that would be a great thing to do, primarily because I think raising the saving rate would be a wonderful thing. But the so-called culture of savings started in 1982. It was alive and well through 1986, allegedly, when the regulations were changed; and just for the record, the saving rate fell between 1981 or 1982 and 1986.

Mr. MCCRERY. Well, there is a lot of reason for that.

Mr. GALE. Right. But there are also lots of potential ways IRAs can work. The culture of saving idea is one idea, the asset shifting idea is another idea, and there is no reason to think that the culture of saving is the way things work.

Mr. McCRERY. But you do think Mr. Steffens is right. If we could create a culture of savings in this country, would it be a good thing?

Mr. GALE. Absolutely, but I would underline the "if," and I would also note that it doesn't seem to me that we know how to do that yet.

Mr. McCRERY. There are a lot of things that we are not real sure about.

Mr. BRENNAN. Mr. McCrery, may I comment on that? One of the things we have proven time and again is that education about savings has a tremendous impact on people's behavior, whether it involves a company-sponsored retirement plan or something else. Mr. Steffens mentioned earlier the kind of marketing and education that would go on with the advent of a renewal of interest in IRAs; and there is documented proof that in site-specific examples, education works. It raises participation rates in defined contribution plans. This results just simply from making people aware of the benefits of the plan. So I would be much more in your camp as to what the prospects for additional savings would be if we were to broaden awareness of the subject.

Mr. STEFFENS. Mr. McCrery, yes. You know, it is interesting to know that in 1986 $38 billion went into IRA accounts; after they changed the law, it dropped to $14 billion and then to $8 billion. Our estimates are that had they left the law as it had been, we would have had $50 to $60 billion at a minimum going into IRAs annually today. Savings rates came down slightly during the IRA period, but they plummeted from 1986 to the present. Some 40 percent of this decline in savings rate could in fact be justified by the simple decline in the IRA area. So it is pretty clear to us that taking away IRAs produced a dramatic, immediate decline in the savings rate.

Mr. McCRERY. Thank you, Mr. Chairman. I want to thank Mr. Steffens and Mr. Brennan for injecting a little common sense into this debate.

Mr. THOMAS. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. I want to explore just a little further the culture of savings in our country.

Having my own profit-sharing plan in my small company, I remember when I dissolved it, and one of the reasons that I dissolved it was what you talked about, Mr. Brennan—they were going to be changing the rules, they were going to be taxing these things in the future. And I think that one of the incentives that we need to build in this country is stability, where the rules aren't going to change and a system that is very easy to use.

In my profit-sharing plan, I had no idea what they were doing with it. I had to rely on somebody else to set this up for my savings as well as my employees.

But I also want to get to a further point, and that is people that are about my age or younger, or maybe even a little older are looking at Social Security as not being there in the future. Mr. Gale, I disagree with some of what you said because I don't think you are taking into account the bigger picture of what we need to do.

I think we need to educate the whole of America, because reality is, Social Security, if it is there, is going to be very little. We need to take personal responsibility for ourselves. It is going to be easier; and as Congress, we have to set up a program that is easy to use, that is not going to change.

Mr. Brennan, your comments.

Mr. BRENNAN. Well, I think your point is very well taken. First, complexity is intimidating and complexity is a deterrent. People who could make aftertax contributions to IRAs today are not doing so; they are intimidated because it involves another tax form to fill out, not like a simple $2,000 deduction. We believe wholeheartedly that we can get good results if we accomplish the two things you have talked about—one, allowing people to have some comfort that they have control over their own financial future, a tremendous advantage of an incentive to save; and two, that the deal is not going to change. And people—I imagine we are not so far off in age—worry a lot about the rules changing as they relate to Social Security. It is one of the important concerns that our investors and the public at large have, a changed deal specifically as it relates to Social Security. Anything we can do to give people an incentive to control their own financial future, I think, is of tremendous benefit to America. I believe it will pay dividends, not in a way that is forecastable in an econometric model precisely, but if you believe in the human spirit and the American spirit, people will save—and we will create jobs, we will create capital which will pay for itself over the long haul.

Mr. ENSIGN. We are a little further apart in age. Since I have been here, I have aged about 15 years in the time I have been here.

Mr. Gale, your comments.

Mr. GALE. From 1982 to 1986, we had universal IRAs, we had very heavy advertising from the brokerage industry and the financial industry generally, and this is what contribution rates looked like 5 years after that: 2 percent of the people in the bottom third contributed to an IRA in 1986, 9 percent in the middle third, and 33 percent in the top third, rising to 70 percent in the upper 1 percent of the income distribution.

The advertising can be thought of as partly educating people about the opportunities for and the need for saving. We did that for 5 years, we tried that experiment, and it didn't seem to have much effect on the bottom end of the income or the wealth distribution.

Mr. ENSIGN. Do you think that at that time the realities had set in about Social Security?

Mr. GALE. Actually, I guess I would disagree with that. There was a Social Security Commission in 1983 that substantially raised taxes. That was a bipartisan commission on reform. So Social Security was actually very much in the news at that point.

Mr. ENSIGN. No, I know it was in the news, but I don't think that people had the realization that it wasn't going to be there.

Mr. GALE. I don't think anyone believed that that solution was a long-term solution, and it was certainly in the papers a lot.

Mr. ENSIGN. OK.

Mr. Steffens.

Mr. STEFFENS. A couple of things: 75 percent of all of the contributions that went into IRAs in 1986 were from people that earned under $50,000. I also think that if you take a look at savings, it is certainly a fact that 100 percent of the savings in this country come from people that earn over $28,000. And so clearly, when you look at the absolute bottom quartile or bottom quintile of the American population in terms of income, they are having a very difficult time paying their bills and buying food and providing the absolute necessities of life. So to look at this in terms of the absolute bottom, IRAs probably are not going to work directly. But the jobs that they help create and their positive impact on the economic environment will be a benefit for all Americans, regardless of their income level.

Mr. ENSIGN. Thank you, Mr. Chairman.

Mr. THOMAS [presiding]. Thank you very much.

Mr. Levin.

Mr. LEVIN. Thank you. Let me follow up, because I am trying to reach a conclusion and haven't on this proposal. What percentage of the tax earners today more or less qualify for an IRA?

Mr. STEFFENS. Thirty-eight percent, and it is declining.

Mr. LEVIN. Qualify.

Mr. STEFFENS. Thirty-eight percent. And it is declining; basically, as incomes rise, it is declining every year because in 1986 income caps were not indexed for inflation.

Mr. GALE. Just one comment on that. All people who earn money are eligible for an IRA, the question is whether you get the deduction at the beginning or the end of the——

Mr. LEVIN. Right. So what percentage of people who would benefit from investment in an IRA taxwise today participate?

Mr. GALE. Of the 38 percent, if that is the right number of people who are eligible for deductible IRAs, participation is down around, I think, about 6 to 10 million tax returns, which suggests about one-fifth or one-sixth of the people that are eligible to participate.

Mr. LEVIN. Because the testimony that comes later says over 90 percent of those eligible to utilize the tax-deferred IRA choose not to do so. So I am not sure we can figure out in the next few minutes the exact percentages we are dealing with, but it seems to be clear that a very large percentage of those who are now eligible do not utilize the IRA. Isn't that true? I mean, it is way more than half?

Mr. GALE. Yes, true, definitely.

Mr. STEFFENS. That is true. But I think you also have to look at the income makeup of the eligibility. Since they have reduced the income levels to that extent and you take a look at the $40,000 joint cap and the $25,000 circumstance, when you begin to take a look at those individuals that are in those income brackets, many simply are not net savers at the present time. So current IRA limits exclude the heart of the middle class, two-income families in the $50,000 to $75,000 range, that would, in fact, be significant participants in a new IRA program.

Mr. GALE. But this is the whole point. People that don't save in other forms also don't save in IRAs. The people that save a tremendous amount in other forms also do save in IRAs.

Ms. MOHR. If I could respond, Congressman.

Mr. LEVIN. That is the issue, it seems to me, whether Dr. Gale is right or wrong, because you seem to say that most of the earning—most of the savings will come from those in middle or higher brackets.

The reason that IRAs aren't working now is because those who are eligible for the best benefit don't have the money to save. So then the question becomes whether there will be a tremendous influx from people who are between $50,000 and $75,000 and what the evidence is that they are the ones who would really invest; or whether more of the investment would come from those in much higher income brackets who already have an array of investment opportunities, and whether you are not just moving their investments from one place to another. It seems to me that is the issue, isn't it?

Mr. GALE. The evidence is overwhelming that in any income category it is the people with a lot of other assets that then also contributed to IRAs.

Mr. BRENNAN. I think whatever the evidence showed, it is historic evidence—and I think one of the points that is very important to make is that we face a new situation. The baby boom generation is a very important part of this issue, and they are now 10 years older, roughly, than when IRAs were universally available. The issues facing that generation are very important. And I think Mr. Steffens would agree that this generation is one of the key target markets for us as an industry, but one of the key target beneficiaries as well. They are 50, or approaching 50, and that is——

Mr. LEVIN. And they are in what income brackets, $50,000 to $75,000?

Mr. BRENNAN. No, no, 50 years old.

Mr. LEVIN. But what income brackets?

Mr. BRENNAN. The administration proposes raising the cap for deductible IRAs to $80,000, so you are raising the potential beneficiaries of a deductible IRA significantly. And I think it is important to recognize that the makeup of that marketplace has changed dramatically in those 10 years; that baby boom generation is rushing toward retirement.

Things are very different than they were in 1982 when the universal IRA came in the first time. So I think a lot of the statistics, while I am sure are valid, because they are done by credible people, may or may not be predictive of future behavior. I don't think we can forecast behavior with accuracy. We have to rely on the marketplace to tell us what will happen.

Mr. THOMAS. The gentleman's time has expired.

Does the gentleman from Virginia wish to inquire?

Mr. PAYNE. Thank you, Mr. Chairman. I want to thank the panel. I think you have done a good job of explaining the various proposals, and the IRA proposal in particular. I think you make a good case concerning education and concerning the tax incentives and the resulting savings rate increase.

I am somewhat puzzled, though, by some information; and I would like to, if I could, Mr. Steffens, ask you about your testimony on the first page. You have a chart that shows the U.S. personal savings rate.

Mr. STEFFENS. Yes.

Mr. PAYNE. This personal savings rate concludes the U.S. personal savings rate has fallen 50 percent since 1970 and demonstrates that phenomenon. And what this shows is, from 1970 to 1984, that the rate is up and down, but around 8 percent.

Then, in 1984, there is a fairly precipitous decline until the year 1987, and it drops from actually 8 percent to roughly 4 percent; and then from that time, 1987, to present it stayed pretty much at 4 percent.

The decline, it seems, began in 1984, and that is at the same time that the data on the next page says that the very highest amount of IRAs were sold. In 1984, 1985, and 1986, sales were $35 billion, $38 billion and $38 billion respectively. Are there other things going on that we should be considering in terms of personal savings that would have occurred that would have made this change in 1984 as dramatically as it did occur?

Mr. STEFFENS. I think that the data in part reflects other economic factors at that particular time and that these impacted savings rates. But I believe the primary decline shown on those charts came after 1986, and so they had declined to about 6.5 percent in 1986, and then it went down some 40 percent from 1986 to the present time, where it has stayed somewhere in the 4 to 4.5 percent range. So the changes that came about in 1986 clearly had a significant impact on what happened, and as I said before, some 40 percent of that decline could be represented by the decline in IRA contributions alone.

Mr. PAYNE. So then the change from 1984 to 1986 of 1.5 percent, you would see that being related to economic conditions at the time?

Mr. STEFFENS. Yes.

Mr. PAYNE. And then beyond that, these changes, to some great extent, were due to the change in the law as it related to the deductibility of the IRA investments?

Mr. STEFFENS. Yes, sir, that is correct.

Mr. PAYNE. Let me ask Dr. Gale one question having to do with IRAs and tax policy in general. Clearly, it seems that you are not advocating IRAs as a good tax policy in terms of inducing increases in savings. Are there tax policies that you would recommend to increase our savings rate which could occur not at the expense of increasing the deficit?

Mr. GALE. There may not be tax policies, but there may be other policies, in particular regarding pensions, that could use some improvement and, I think, would have a potential to raise the saving rate with little or no impact on the budget deficit.

Mr. PAYNE. But you are not making any recommendation about anything that should be done in the Tax Code that could encourage personal savings and not hurt the deficit?

Mr. GALE. I think ultimately the Tax Code is a very weak way to affect personal saving. The saving rate has declined for a number of reasons for a number of years in many countries. It has to do with things like liberalization of credit markets, the slowdown in wage and income growth, increasing transfers to the elderly; and tax policy is a very small part of that, either positive or negative, in terms of generating solutions.

If we are going to raise the saving rate, ultimately it will have to be done through the pension system, since saving for retirement is the biggest component of saving. Pensions are different from saving incentives in that pension participation is less optional, so you force low savers to save, and in that pension balances are less liquid so that the money can't be taken out before people retire, so you get more saving per initial contribution. But I am not sure if you want to call that a tax policy question or pension policy question.

Mr. PAYNE. One last comment. Were you aware that when the Treasury looked at the first 5 years, they said there would be no impact on the Federal budget deficit as a result of this proposal we are talking about today?

Mr. GALE. Of the backloaded IRAs?

Mr. PAYNE. That is correct.

Mr. GALE. Yes. Backloaded IRAs are all fiscal time bombs. It is important to note that when we say something is paid for in Washington, we mean it is paid for for the first 5 years. You could pay for frontloaded IRAs just by not enacting them until 5 years from now, and then there would be no budgetary costs for the next 5 years, but everyone would recognize that as a budget gimmick.

The backloaded IRA has costs that are all in the future and the budget doesn't require you to take account of the costs. So I think the true revenue costs are much, much bigger than the 5- or even the 10-year estimates.

Mr. PAYNE. Thank you, Mr. Chairman.

Mr. THOMAS. Thank you very much. Let me thank the panel and tell you that there is an ongoing frustration of members of the tax committee—did you want to make a comment?

The gentleman from New Jersey.

Mr. ZIMMER. Thank you, Mr. Chairman. I would like to ask a couple of questions of Mr. Steffens, and the first one comes right off the comment that was just made.

Mr. Steffens, other than the scoring issue in terms of budgetary projections, do you see any significant benefit of a backloaded IRA as contrasted to a frontloaded IRA?

Mr. STEFFENS. Well, I think that if you take a look at the backloaded IRA, it clearly provides a tax benefit to the savings that come from the amount of money, dividends, interest, capital gains, et cetera, that an individual would put into that program. In our research, Americans have viewed it two different ways. In one case, they worry about whether government policy would let the back-end incentive stand. More importantly, people are concerned about rising tax rates in the future, so there is clearly an incentive to save in a back-end account since there would be no taxes on that money no matter what happened to tax rates in the future.

Mr. ZIMMER. So you think there is independent merit to backloaded IRAs beyond the budgetary scoring and the question of the budget window?

Mr. STEFFENS. I think that there is a benefit, not only from that standpoint. Budget scoring deals with the cost on the one hand, but it doesn't talk about the benefits. And as I have said, there are numerous benefits in terms of helping people find the dollars that they are going to need 20 years down the road, in retirement. We don't have nearly enough in the way of savings to do that currently.

Second, the impact on the economy from a jobs creation standpoint, a competitive standpoint, and the reduction in interest rates would be very positive.

Mr. ZIMMER. Could you please elaborate on the part of your testimony that addresses the important issue of whether IRA tax incentives create new savings, or merely reshuffle existing savings? That is really a critical issue to many of us.

Mr. STEFFENS. There were a number of studies done. Venti and Wise basically looked at this issue and came to the conclusion that 66 percent of the money that went into IRAs was in fact new savings. There have been other studies done at places like Harvard and MIT and Dartmouth, as well, reinforcing those findings, that in fact the IRA created and stimulated new savings.

Mr. ZIMMER. In your testimony you also note that the provisions of the 1986 act that restricted IRAs actually curtailed the total amount of IRA assets by about $400 billion. Could you briefly tell the committee how that figure was arrived at?

Mr. STEFFENS. Yes. In 1986 IRA contributions were about $38 billion. It declined to about the $14 billion level and now has declined to about $8 billion. So the shortfall has been $25 billion a year or more since 1986. If this money, plus the interest that would have been earned, had been in an IRA, approximately $400 billion of additional IRA saving would be available today for investment in the U.S. economy.

Mr. ZIMMER. Do you have an estimate of how much of that $400 billion is simply not being saved?

Mr. STEFFENS. Well, it is difficult obviously to determine the number exactly, but a simple review of the U.S. saving figures shows that some 40 percent of the decline of personal savings from 1986 to 1994 can be accounted for by the decline in the IRA savings alone.

Mr. ZIMMER. Thank you very much.

Thank you, Mr. Chairman.

Mr. THOMAS. Does any other member wish to inquire?

Getting back to the general frustrations, I want to thank the panel for their testimony, because you shared with us the concerns that I and other members have had. Oftentimes, we will lecture the private sector on their quarter-to-quarter decisionmaking, and that they ought to focus on a longer term decisionmaking pattern, and yet we deal with a societal decision on what amounts to a quarter-to-quarter decision on, as Mr. Gale indicated, a 5-year window. It is quite clear that in terms of dealing with the IRA, it is pay-me-now or pay-me-later, but it is always dealing with that 5-year frame, and it is very frustrating for us.

I know in the last Congress, dealing with preventive care in the health care area, you run into the same profile of trying to make decisions that clearly are going to have an impact on the society for several decades. The tools that we use for examining it, from a budget scoring point of view, I believe are inadequate for an actual assessment. I know it is difficult talking about 10, 15, 20 years out, but I think there are some basic truths that you can deal with.

In addition, the gentleman from New York's comments about the fact that it is going to be a loss to the Federal Government, I appreciate, Mr. Hazen, your immediate response that it might deal with government bookkeeping impact, but society at large would benefit. Individuals would benefit following that policy. It is true that interest payments are moving ahead of defense shortly as the second largest item of Federal payments. But number one is payments to individuals, and this obviously would hopefully affect, over the long run, government's payments to individuals by virtue of individual savings.

There is a larger question, and I want to ask it in a general sense. In trying to put together packages which might get people to change behaviors—and I think, Dr. Gale, I agree with you that perhaps the Tax Code is not the best way to change behavior in these areas, but it is one of the ways that we can do it—that you have to put together a package that gets people to respond who have grown up in significantly different periods. It is not, to me, just an age difference between people who grew up in the Depression versus people who grew up in the postwar years, but it is a mental set about what tomorrow is going to bring and that any single response is not going to be universal in terms of behavior types.

I also think that government decisions in the late eighties, and now the early nineties, do not give folks confidence that if they begin to make life plans based upon government's decision today, that government won't necessarily change that in the 1986 tax bill in a retroactive way, which destroys people's ability to plan for their own future based upon the certainty of a government decision.

Any reaction from any of you in terms of that kind of policymaking?

Mr. Feltman.

Mr. FELTMAN. Mr. Chairman, you are correct, our research shows a great deal of skepticism among taxpayers. They are concerned about changes coming in the future that will wipe out everything that they have done, and one of their reactions to that is to say, I need to take greater control of my own destiny. We see this manifested when we hear that the baby boomer generation and generation X doesn't think that Social Security will be there when they get there. But it is manifested also in employees asking whether I can take early retirement at age 60 and be sure that I will continue to get my Social Security, or if when I am 63 or 64, Social Security is bankrupt, will it go away from me, too? So if people are trying to make decisions on when they retire, based on a fear about Social Security, we do have a great deal of anxiety out there.

Mr. THOMAS. Ms. Mohr.

Ms. MOHR. Mr. Chairman, I would also like to say that representatives of industry, and particularly the members of the Savings Coalition, we would very much like to form a partnership with your committee in terms of whatever law is passed, to have education, to have vehicles by which we can educate consumers.

I was very active between 1981 and 1986 in putting forth for my company a major national sales campaign on the IRA, as were many of the organizations represented here today. The IRA was simple. People could understand that if they put $2,000 in on April 15, they would see an immediate tax return.

We have talked here today about the back-ended IRA. It is a little more complicated, but with the help of industry, we believe that we can put that forward as a way for aging baby boomers to save for their retirement. Clearly, as an aging baby boomer, I am looking at my 76-year-old mother and my 75-year-old father, who are living on Social Security; and I feel as if my contribution out of my paycheck every 2 weeks goes directly to support them.

I also have an 11-month-old son, and I am thinking about how long will I have to work to fund his education 18 years from now? And this type of squeeze, as well as planning and saving for my own retirement, certainly hits a lot of aging baby boomers. We believe, as representatives of the industry, that we can work with the tax committee to put forth simple agendas and help middle-class America.

Mr. THOMAS. Thank you.

Dr. Gale, in your testimony on IRAs and the 401(k)s, you indicated that you have done quite a bit of work, and it is apparent with your testimony. To what extent have you focused that investigation on these back-ended IRAs, which I believe are relatively new approaches?

Mr. GALE. It is hard to do empirical work on back-ended IRAs because they haven't been around very long, and the back-ended IRAs that are around really aren't like the ones that have been proposed. In some of the simulation models that we have done, where you can make up your own IRA and make up your own data, you get pretty much similar long-term effects from frontloaded and backloaded.

Mr. THOMAS. Mr. Steffens, obviously the testimony that you gave indicates that you have done some research, and apparently you are cutting edge on this; and I would ask that if you have any back-ended research that isn't covered in your testimony, that you would make it available to us, because I think this is an area obviously that the committee wants to explore.

I thank all of you for your testimony. I appreciate it very much.

[At the time of printing, no information was received.]

Mr. THOMAS. I would ask that the next panel come forward—John Bachmann, Raymond McKee, Paul Reid, and I believe it is Jay Buchert—if you could come forward, please. I will tell all of the panel members that, without objection, their written testimony will be made a part of the record, and that you may proceed however you wish in informing the committee for your 5 minutes. And I will move from my right, your left, across the witness table, and I will begin with Mr. Reid.

STATEMENT OF PAUL S. REID, PRESIDENT-ELECT, MORTGAGE BANKERS ASSOCIATION OF AMERICA, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN HOME FUNDING, INC., RICHMOND, VA.

Mr. REID. Mr. Chairman and members of the committee, I am Paul Reid, president and CEO of American Home Funding, based in Richmond, Va. I am also currently serving as president-elect of the Mortgage Bankers Association of America, known as MBA. We very much appreciate the opportunity to appear here today.

The principal objective underlining H.R. 6, that of helping families attain their version of the American dream, is one that is shared by MBA and its members. Without a doubt, one of the key elements of that dream for tens of millions of Americans, is the ability to own a home.

MBA believes H.R. 6, the American Dream Restoration Act, would help accomplish that objective. In fact, we believe it would greatly assist in efforts to bring the dream of home ownership within the grasp of tens of thousands of Americans for whom it is still beyond their reach. As such, MBA is very supportive of your efforts.

MBA and its members are dedicated to financing home ownership throughout the United States. In fact, last year alone, MBA's members financed the first homes purchased by over 700,000 families.

Yet home ownership rates are falling, rents are increasing and government assistance for housing is being cut. That is why the American Dream Restoration Act is so important at this time. Only by increasing the rate of savings can we make the dream of home ownership a reality for tens of thousands of would-be home buyers.

MBA believes that Federal tax policy can help in this regard by accomplishing two objectives. First, it should do more to encourage savings by a broad spectrum of the population. This will help decrease the cost of mortgage credit, thereby making housing more affordable.

Second, it should permit the use of savings for certain critical purposes, such as the purchase of a first home. For most Americans, buying a home is the single largest purchase of their lifetime. It also proves to be one of their most important savings vehicles. In fact, home equity buildup ranks behind only pension funds as the source of individuals' accumulated wealth. This type of investing should be strongly encouraged by Federal tax policy.

We believe creation of ADS accounts will encourage savings. Further, early withdrawal provisions will encourage young Americans to begin to save before they might otherwise, providing more opportunities to invest in their futures through the purchase of a first home.

MBA's research shows that the problem of assembling the downpayment and related closing costs poses the principal barrier to home ownership for those trying to purchase their first homes. The explanation for this fact is Americans' failure to save.

As I explain in greater detail in my written comments, there is a clear need for new and expanded sources of capital that young Americans and those living on low and moderate incomes can tap to assist in their first purchase of a home. We believe the proposal to create American dream savings accounts will help in this regard.

Despite the many positive attributes of the proposed legislation, we believe it can be improved. With that thought in mind, let me make the following four recommendations:

First, we strongly recommend that you waive the 5-year withdrawal restriction for funds that have been transferred from an existing IRA account. MBA estimates that if the median first-time home buyer were able to access an additional $5,000, as many as 491,000 more households would qualify to purchase a home. Yet, many are unable to do so, making home ownership an impossible dream.

Research shows that approximately two-thirds of people currently renting would like to eventually own a home. Of these, about 234,000 would like to become homeowners within the next 5 years. However, failure to expand the withdrawal provision to permit use of funds already held in an IRA account will deny them the opportunity to use their savings now to fulfill their dream of home ownership.

Second, we strongly encourage you to permit taxpayers to withdraw their ADSA funds, or their existing IRA deposits when transferred to an ADSA account, to help a child or a grandchild make a downpayment to purchase a first home.

The assistance of family members is often required for an individual purchasing their first home. Studies have shown that, on average, 15 percent of each first-time home buyer's downpayment was made by a relative of the purchaser. Clearly, there is a tremendous desire on the part of many individuals to assist family members purchase their first home.

The ADSA proposal already permits individuals to use their savings to assist family members. Expanding the existing language would greatly improve the act and help assure its success.

Third, MBA believes the legislation could be improved by offering taxpayers the option of taking an up front deduction, and paying taxes upon withdrawal. This would provide the greatest amount of flexibility for taxpayers, and provide the greatest incentive for new savings. Options on this approach should be explored.

Finally, other Members of Congress have already introduced and are currently contemplating various alternatives to the proposal contained in H.R. 6. One of these would permit an IRA custodian to use funds as a loan or equity investment for the downpayment on the purchase of a first home. We encourage you to seriously consider this and other proposals when deliberating the final form of the proposed legislation.

In conclusion, MBA believes that the purchase of a home is one of the most important and frequently used forms of long-term savings made by Americans. As such, we strongly support your efforts to increase the level of savings through the creation of American dream savings accounts, and the use of such funds for the purchase of a first home. Without a doubt, the proposal will significantly help many Americans attain their version of the American dream.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF PAUL S. REID, CMB
President and CEO, American Home Funding, Inc.
on behalf of
The Mortgage Bankers Association of America

Mr. Chairman and Members of the Committee, I am Paul S. Reid, President and C.E.O. of American Home Funding, Inc., based in Richmond, Virginia. I am also currently serving as President-Elect of the Mortgage Bankers Association of America (MBA).[1] Accompanying me today are Michael J. Ferrell, MBA's Senior Staff Vice President and Legislative Counsel, and Robert G. Josephs, MBA's Director and Associate Legislative Counsel.

MBA very much appreciates this opportunity to appear before you in support of the proposal to create American Dream Savings Accounts (ADSAs). MBA would like to commend Chairman Archer for holding these hearings, and commend Representatives Crane, Nussle, Salmon, and their more than 110 co-sponsors, for introducing HR 6, the "American Dream Restoration Act" (the "Act"), in which the proposal is incorporated.

The principal objective underlying HR 6 -- that of helping families attain their version of the American dream -- is one that is shared by MBA and its members. Without a doubt, one of the key elements of that dream for tens of millions of Americans, is the ability to own a home. It is far and away the possession that is the most valued in our society. Surveys and opinion polls repeatedly attest to this. When asked what they want most -- more money, a better job, -- Americans overwhelming say they want to own their own home. It is also the best way that average families can accumulate wealth and ensure financial security. It's their nest egg. It allows them to look toward the future, to fund their children's educations or their own retirements. Home ownership empowers people. It is regarded as one of the ultimate achievements of the American way of life.

MBA believes HR 6 would help accomplish these objectives. In fact, we believe it would greatly assist in efforts to bring the dream of home ownership within the grasp of tens of thousands of Americans for whom it is still beyond their reach. As such, MBA is very supportive of your efforts.

II. MBA'S ROLE IN FINANCING HOME OWNERSHIP

MBA and its members are dedicated to financing home ownership throughout the United States. Mortgage bankers serve a critical role in this process. By linking capital sources with demand for financing, our members have made housing affordable and available for all people across the economic spectrum. We have made home ownership possible for millions of Americans who would otherwise be unable to achieve it.

Our role has been of critical importance, especially for undeserved areas and populations, including minorities, those living on low- and moderate-incomes, and first-time homebuyers. We have provided financing to 52 percent of American families purchasing a home in each of the past two years. In 1993, MBA's members financed first homes purchased for over 700,000 households. Beginning in the late 1960s, we have also been involved in financing and producing the great majority of low-income housing units in this country. And today, we are renewing our commitment to take a responsible role in addressing the very difficult problems of providing home ownership opportunities for these target populations.

III. AMERICAN DREAM SAVINGS ACCOUNTS

Despite the efforts of MBA, and others dedicated to providing the opportunity of home ownership to all Americans, much more can and should be done. Home ownership rates are falling for the next generation of young Americans, for low- and moderate-income households, and for minority populations. At the same time, the stock of affordable rental housing is decreasing, leaving available only higher rental units. In spite of these statistics, government subsidy and assistance programs, already able to serve only a small percentage of those in

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[1] MBA is the national association representing exclusively the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of nearly 2,900 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field.

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need, are being scrutinized by Congress with the thought of cutting back or eliminating programs to divert funds for other purposes.

That is why the American Dream Restoration Act is so critical at this time. Only by increasing the rate of savings can we make the dream of home ownership a reality for tens of thousands of would-be homebuyers. MBA believes that Federal tax policy can help in this regard by accomplishing two objectives. First, it should do more to encourage savings by a broad spectrum of the population. Americans' rate of savings is lower than that of any other industrialized nation. Encouraging savings will ultimately help decrease the cost of mortgage credit, thereby making housing more affordable. This will ultimately bring the dream of home ownership within reach of millions of American families.

Second, it should permit the use of savings for certain critical purposes, such as the purchase of a first home. For most Americans, buying a home is the single largest purchase of their lifetime. It also proves to be one of their most important savings vehicles. In fact, home equity buildup ranks behind only pension funds as sources of individuals' accumulated wealth. This type of investing should be strongly encouraged by federal tax policy. By building incentives into the U.S. Tax Code that encourage people to save, and permitting the use of such savings to purchase a home or other essential items, Congress can accomplish the primary objective of this legislation and assure its success.

The provisions in the Act creating ADSAs would help accomplish both of these important objectives. We believe creation of ADSA accounts will encourage savings that would not otherwise occur by permitting deposits to accumulate tax-free, and by permitting their tax-free withdrawals at prescribed times and under prescribed circumstances. Further, allowing the early tax- and penalty-free withdrawal of ADSA funds for the purchase of a first home will encourage young Americans to begin saving earlier they might otherwise. This will provide them with more opportunities to use such savings to invest in their futures through the purchase of a first home.

IV. LACK OF ADEQUATE SAVINGS

The principal barrier to home ownership for those who would like to purchase their first homes is that of assembling the downpayment and related closing costs associated with the acquisition.[2] Yet, the evidence is clear that a tremendous number of Americans are not able to save adequately to pay for their retirement, or other critical needs, such as the purchase of a home. In fact, the rate of savings in America has dropped substantially since 1986. For example, the average personal savings rate dropped in 1993 to about 4.1 percent of disposable income,[3] well below the amount that many financial advisers and analysts recommend as necessary to provide adequately for retirement,[4] and 32 percent below 1986 levels. Indeed, the average rate of personal savings has dropped by about 55 percent during the 20 years from 1973 to 1993.

V. IMPACT ON POTENTIAL HOMEBUYERS

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[2] The costs associated with purchasing the median price starter home ($94,200) include the following:

Downpayment	$9,420
Loan Fees	$1,130
Title Charges	$1,525
Recording Fees	$ 650
Home Inspection	$ 265
Advance Interest and Insurance Premium	$2,968
TOTAL	$15,958

Note: Closing costs vary widely by state

[3] "Survey of Current Business." Bureau of Economic Analysis, U.S. Department of Commerce.

[4] Dr. B. Douglas Bernheim of Princeton University stated his belief in a recent study, that most households headed by individuals age 35 to 45 years old generally need to save 9 to 19 percent of their after-tax income in order to achieve a standard of living after retirement comparable to that enjoyed by their household in pre-retirement years. These numbers increase to between 13 and 25 percent for those who do not expect to be covered by an employer-sponsored pension plan upon retirement. "Is the Baby Boom Generation Preparing Adequately for Retirement?," January 15, 1993.

MBA believes the low savings rate experienced in most age categories is a significant cause of the current decline in home ownership rates. Nowhere has this correlation between low savings rates and low rates of home ownership been more pronounced than among our country's future potential homebuyers, those age 25-34, who comprise the largest percentage of those purchasing their first homes, and those younger than 25. For example, a recent study by the Joint Center for Housing Studies of Harvard University[5] indicates that home ownership rates have dropped during the 20 years from 1973 to 1993 for all age categories younger than 55. Yet the drop was most dramatic for those in the 25-34 year old age categories, whose rate of home ownership fell throughout the 20 year period. Indeed, home ownership for 25-29 year olds during that period fell 20.6 percent, and home ownership among 30-34 year olds dropped 15.2 percent. Not surprisingly, the savings rates, as of 1993, for these two age categories, were almost negligible.

We believe the principal reason why low savings rates are so directly correlated to low rates of home ownership is that inadequate savings prevent young Americans, and those living on low- and moderate-incomes, from obtaining enough money to make the downpayment for a house and pay the settlement costs. In fact, studies by MBA, other trade organizations, and non-partisan policy research groups have repeatedly identified this as the number one impediment to home ownership for young Americans.

To gauge the extent of this problem better, MBA recently hired the Gallup organization to conduct a nationwide survey of Americans' perceptions regarding their ability to purchase a home. Among other issues, the survey sought to identify the most significant impediments for individuals in obtaining a mortgage loan. Not surprisingly, the lack of savings for a downpayment was identified as the number one problem. Of those surveyed, 55 percent said it would pose a problem. Of these individuals, 20 percent believed this problem would be insurmountable, and 8 percent were not certain if the problem could be overcome.

Steadily rising housing costs, and incomes that continue to trend downward relative to the cost of living, make it even more difficult for would-be homebuyers to overcome these barriers to home ownership. Studies have repeatedly shown that the relationship between income and home prices is the most important factor affecting individuals' ability to find the funds to make a downpayment and pay for closing costs. Historically, these costs have remained high relative to income, and remain so today. This is due, in large part, to the significant housing price inflation experienced in the 1970s and 1980s. To this day, the incomes of first-time homebuyers, as adjusted for inflation, are 17 percent lower than in 1972. At the same time, today's home prices, adjusted for inflation, are 10 percent higher than in 1972. To this day, there is little movement toward an equilibrium of housing prices and income. Thus, home ownership has remained unattainable for thousands of Americans.

This obstacle has remained the most pronounced for families surviving on low and moderate incomes. In 1993, the average cost of a home was $94,200. Using a typical downpayment of 10 percent, and total average closing costs as a model (see footnote 2 above), a potential purchaser would have to raise approximately $15,958 to purchase such a home in 1993. Downpayment and closing costs together represent a startlingly high 64.3 percent of a first-time buyer's annual income. This percentage has changed very little since 1987, and represents a significant increase since the 1970s. And data indicate that incomes are still about 17 percent less than what is currently needed to purchase a first home and pay the mortgage.

VI. THE NEED FOR NEW SOURCES OF CAPITAL

The information described above leads MBA to the conclusion -- that there is a clear need for new and expanded sources of capital that young Americans, and those living on low- and moderate-incomes, can tap to assist in their first purchase of a home. This can be accomplished in two ways. First, the U.S. Tax Code should be modified to permit would-be home purchasers to gain access to existing pools of capital that are currently unavailable until retirement. Second, incentives should be provided to encourage savings that can expand available capital sources.

The ADSA proposal would go a long way towards accomplishing these objectives. First, permitting taxpayers to roll over their existing Individual Retirement Accounts (IRA's) into their new ADSA accounts will help many taxpayers to tap existing sources of capital for a first-time home purchase. Although many taxpayers in the 28 percent or higher marginal tax brackets may prefer to retain their IRA accounts in order to pay less taxes at what will likely be a lower post-retirement rate, this option may be especially attractive for those who pay taxes currently at a lower marginal rate. Second, permitting earnings to accumulate tax-free, and allowing early (pre-retirement) withdrawal for special purposes, such as purchasing a first home, will also expand the sources of capital that might not otherwise be available to many taxpayers.

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[5] "The State of the Nation's Housing 1994," the Joint Center for Housing Studies of Harvard University.

VII. IMPROVING THE ADSA PROPOSAL -- MBA RECOMMENDATIONS

Despite the positive attributes of the proposed legislation, more can and should be done to assure the Act obtains its objectives. In short, although MBA supports the ADSA proposal, we believe it can be improved. With that thought in mind, we respectfully submit the following recommendations for your consideration.

1. Waiver of the Five-Year Moratorium On Use Of Funds When Transferred From IRA

First, we strongly recommend that you waive the five-year withdrawal restriction for funds that have been transferred from an existing IRA account. Such a requirement may unnecessarily forestall thousands of potential homebuyers from purchasing their first home. MBA estimates that if the median first-time homebuyer were able to access an additional $5,000, as many as 491,000 more families would immediately qualify to purchase a home. Yet, for those unable to raise the funds necessary to make a downpayment this goal becomes impossible to attain. Surveys also indicate that approximately two-thirds of renter households would like eventually to own a home. Of these two thirds, 70 percent would like to purchase their first home within the next five years. If able to do so, approximately 234,000 more households could become first-time homeowners within this period. However, failure to expand the withdrawal provision to permit use of funds already held in an IRA account will deny them the opportunity to use their savings to fulfill their dream of home ownership.

Some have suggested the five-year holding requirement, included in the current proposal, improves its budget projections for the critical five-year period following authorization, because taxes must be paid on amounts rolled from IRA into ADSA accounts. However, permitting use of rolled-over funds need not cause any loss of revenues if a withdrawal is permitted only after paying all taxes owed. Imposition of a five-year waiting period, therefore, will only serve to prevent, or unfairly delay many low-, moderate-, and middle-income Americans from buying their first home.

2. Allow Parents To Use Funds To Help With Children's or Grandchildren's First Home Purchase

The current ADSA proposal would permit an individual to make a penalty- and tax-free withdrawal of ADSA funds to pay for a child's or grandchild's higher education expenses. MBA agrees with, and commends you for permitting the use of savings to pay for a higher education. However, MBA strongly encourages expansion of this provision to permit taxpayers to withdraw their ADSA funds, or their existing IRA funds immediately upon transfer to an ADSA account, to help a child or grandchild make a downpayment to purchase a first home.

The assistance of family members is often required for an individual purchasing their first home. For example, data in a home purchase settlement transaction survey conducted by the Chicago Title Insurance Company, indicate that on average, 15 percent of each first-time homebuyer's downpayment was made by a relative of the purchaser. Clearly, there is a tremendous desire on the part of many individuals to assist family members purchase their first homes.

Also, most individuals who are forming their own families, and trying to join the ranks of this country's homeowners, are past the age at which they are studying for a higher educational degree. Thus, their parents and grandparents will be beyond the point at which they can help pay for college or graduate school. Such individuals may very much hope, however, to assist a family member in purchasing their first home.

We also believe that allowing savings to be used in this manner is entirely consistent with current tax policy. There are many instances where Congress has directed that the Tax Code help families help each other. For example, personal exemptions and those for dependants, are intended to assist individuals who provide and care for their children. The same can be said for provisions that permit taxpayers to deduct allowable medical expenses incurred in caring for children and dependants. These laws recognize the financial responsibility parents assume in caring for their offspring. Many provisions, including the ADSA proposal that allow individuals to withdraw ADSA funds to provide for childrens' and grandchildrens' higher educations, recognize that this responsibility is willingly assumed by parents long after children reach the age of majority.

Permitting the use of funds, in the manner we recommend, would increase the ability of the Act to achieve its principal objective. We, therefore, strongly encourage you to expand the early withdrawal provisions to permit the use of ADSA funds by parents to assist with childrens' and grandchildrens' first-time home purchases.

3. Deductibility

MBA also believes the legislation could be improved by offering taxpayers the option of taking an up-front deduction, and paying taxes upon withdrawal. This would provide the greatest amount of flexibility for taxpayers, and provide the greatest incentive for new savings. Such an option would truly provide a considerable benefit to working Americans.

We recognize, however, that such an approach may not be possible under current budgetary conditions. We, therefore, strongly encourage you, when preparing your final version of the legislation, to consider variations on the full deductibility option, that might not pose as significant a burden on the U.S. budget. One alternative might be to means test deductions by limiting their availability to individuals with incomes below a certain level.

4. Other Alternatives

Other Members of Congress have already introduced, and are currently contemplating various alternatives to the proposal contained in HR 6. One such alternative, introduced in past Congresses by Republicans and Democrats alike, would permit the custodian of an IRA, at the owner's direction, to use funds to make a downpayment for the purchase of a first home as a loan or as an equity investment. The IRA could also be used to make a loan to a child or grandchild for the same purpose. The funds must be restored to the IRA through repayment of the loan or equity investment when the home is eventually sold.

If such an option were created for existing IRAs, and limited to funds already deposited at the time of enactment of the legislation, Congress could make an existing source of capital available for this important purpose without much additional cost to the Treasury. After all, IRA funds can already be used for the purchase of mutual funds that invest in Government National Mortgage Association (GNMA) mortgage-backed securities -- instruments that are backed by thousands of mortgages on other peoples' homes. This investment option should be expanded to allow the use of such funds to acquire (or make a loan) for investment in the IRA holder's own home, or that of his or her family members.

VIII. CONCLUSION

MBA firmly believes that Congress should do more to encourage savings by the widest range of Americans possible. MBA also believes that the purchase of a home is one of the most important, and frequently used forms of long-term savings made by Americans. As such, we strongly support your efforts to increase the level of savings through the creation of American Dream Savings Accounts, and the use of such funds for the purchase of a first home. Without a doubt, the proposal will significantly help many Americans attain their version of the American dream.

Mr. THOMAS. Mr. Bachmann.

STATEMENT OF JOHN W. BACHMANN, MANAGING PRINCIPAL, EDWARD D. JONES & CO., ST. LOUIS, MO.

Mr. BACHMANN. First of all, thank you for giving us the opportunity to be here on this important topic. I am John Bachmann, the managing principal of Edward D. Jones & Co., and we are based in St. Louis. We represent approximately 1.8 million individual investors in all 50 States. We serve 3,350 communities in the United States, as well as 10 in Canada. Our customers are exclusively individual investors, so this is the only business we know.

We, in talking to them, think we have some sense of what some of the concerns are in that particular area, the people who actually sit down and talk about their feelings and emotions when they discuss investments. And there are some things, some conclusions that we are able to reach.

Savings rates are at an all time low. They are concerned about Social Security and the future problems it faces. They are concerned about their children and, in many cases, their grandchildren's lives; will life be as good for them as they were—the opportunity that they saw? They are bombarded with these topics daily.

As we look at the subject of retirement, there are three components that we see in retirement savings. Social Security, employee-sponsored plans and individual plans. The problems of Social Security are well documented. We have gone from beginning with 42 people supporting 1 person receiving benefits to about 3.5 today and that will be less than 2, based on demographics in the year 2035.

We recognize that our customers, we believe, recognize that for Social Security to survive, it is going to require dramatic changes—either a sharp increase in rates, increase in the retirement age, or some sort of a means test. In any of those cases, they see it as less important in terms of what they can count on in their future.

Employee-sponsored plans are important, but they too are becoming less important, meaning that in the final analysis, people increasingly have to look to themselves to take care of their savings and investment needs. The reality is that people save not only—the importance is not only for their own personal reasons, but for the economy as a whole.

Savings and investment are the fuel for capital formation, economic growth and job creation. The problems we face are not unlike those of all of the Western countries coming out of World War II, where the demographics are surprisingly similar. The World War II baby boom has really affected much of the Western World.

We are here today because we believe that, at least at our firm, that our retirement system is on shaky ground. It needs to be clarified. People need to know what they can look forward to. We think that the first step is to find ways to incent savings and investment, and we can think of no better way than to restore the tax-deductible IRA. Our experience was, it was the greatest experiment in savings for a firm that goes back to 1871 that we ever saw, and people responded when it was implemented and they responded again when it was changed, and they responded by, as was said earlier, by opening accounts and doing business; and then they stopped doing business that way in all too many cases when it was removed. We believe people do need to be encouraged to save, and a tax deduction is a very strong savings.

I was surprised when I heard some speakers say that this is not necessarily strong policy or a way to go, because our experience is that people react very strongly to even subtle changes in the tax laws. We believe in our experience that many of the people making contributions to IRAs were not the very wealthy, but were people of moderate means, kind of at the edge where that initial incentive would cause them either to act or not to act. We think that they understand the importance of investing, and they recognize that by putting a small amount away on a regular basis, it becomes a very large amount; $2,000 a year starting at age 22, at 7 percent, brings about a half a million dollars or more in retirement benefit for these people.

So once we saw the tax deduction eliminated, many of the people just dropped. It was a dramatic drop.

We have seen the studies that suggest IRAs are merely a shift in savings. We have also seen studies that say they create new savings. The truth is, we are not certain that there was enough of an experiment in the IRA to really know what long-term impacts are. There are too many—there is too much static, too many factors that intervened at that time. I can tell you from our own experience and from those of our investment representatives, that more of our clients, particularly younger people, responded when IRAs were tax deductible, and as I said, responded again when they were removed.

Among the proposals, there is a question of front-end and back-end IRAs. It is our view that probably an attractive compromise that we think would make a great deal of sense would be to put a front-end incentive on people who are putting money into IRAs who are under 45 years old, and above 45, to shift to a back-end incentive. We think that young people need a jump start, need a jolt to get started. And the sense of urgency created by that loss of benefit on April 15 is a strong incentive.

By the same token, as people grow older, we know that once the children are out of the home, that the three main concerns are family, health, and independence and freedom in retirement. So we believe that the back-end incentive would be sufficient there. So after age 45, we would suggest that.

I do appreciate the opportunity to provide the committee with our view and what we believe to be the views of many of our clients, and hope you agree that it is time to restore the IRA for American investors.

Thank you.

[The prepared statement follows:]

TESTIMONY OF JOHN W. BACHMANN
MANAGING PRINCIPAL, EDWARD D. JONES & CO.

Before the U.S. Congress Ways and Means Committee
January 31, 1995

Mr. Chairman, I am John Bachmann, the managing principal of Edward D. Jones & Co. I appreciate the opportunity to appear before this Committee to present the views of Edward D. Jones & Co., and more importantly to communicate what we believe to be the views of our clients on the restoration of the tax-deductible IRA.

Edward D. Jones & Co. is an investment firm based in St. Louis, Missouri. We currently have 3,378 Investment Representatives in 3,350 communities across the United States and Canada and serve in excess of 1.8 million customers in the United States. Our firm is unusual, in that our customers are individual investors exclusively. We do not serve institutional clients nor do we cater to clients with very large portfolios, "the rich and famous" if you will. Our clients invest for primarily one reason, to save for their future retirement or to maintain their standard of living in retirement. As you might suspect, they are keenly interested in the savings crisis this country faces.

Our customers read newspapers, watch the news and watch you on C-SPAN. They've heard all the same facts you have...our savings rate is at an all-time low, Social Security is facing future problems and our children's futures may not be as promising as they once were. They are bombarded with these topics everyday. Our clients don't expect the government to take care of them in retirement, but rather they expect the government to allow them, their children and grandchildren to effectively save for retirement. They expect fair treatment.

Let's start with a brief discussion of the problems our clients face.

There are three components to retirement savings. The first is Social Security; the second is an employer-sponsored retirement plan; and the third component is the individual's own personal savings. Over the years, two of these have played a smaller role in providing retirement income.

Currently, Social Security is the largest source of income for many retirees, however, this can't possibly last. The Social Security System will face some significant strains in the years to come. As the baby boomers age, the number of individuals paying into Social Security will continue to decrease and the number of people receiving benefits will increase. When Social Security first began, 42 workers were paying into the system for every one recipient. Right now, 3.4 workers support each recipient. By the year 2035, the ratio will be 1.9 workers per recipient.[1] In addition, people are living longer, which means Social Security benefits must be paid for a longer period of time.

Even though this is not a popular statement, most of our customers believe that Social Security will survive but only be available to those who most need it. They expect changes will be made. Will this mean a dramatic increase in Social Security taxes, an increase in the retirement age, or that Social Security will have to become means tested? Regardless, none of these decisions will be popular.

The second component, employer-sponsored plans is still a good source for retirement income...for some people. With all the down-sizings and corporate restructurings, many people are finding themselves without a job or working for an organization that no longer has the means or the desire to make contributions to a retirement plan on their employees' behalfs. Only about 50 percent of the population is participating in an employer-sponsored retirement plan.[2]

Finally, the third component is personal savings. Unfortunately, the U.S. savings rate is at an all-time low. Who's to blame for this? Are we truly a nation of consumers who cry "SPEND SPEND SPEND" or, rather, does our tax system encourage spending and discourage saving? The reality is people need to save, not only for their own personal reasons but for the economy as a whole. Savings and investment are the fuel for capital formation, economic growth and job creation. Many foreign countries face the same demographic challenges we do and while they have experienced a decrease in personal savings it has not dropped as significantly as in the United States. Perhaps these countries have found a way to incent individuals to save.

I think we would all agree that our retirement savings system is on shaky ground today. So what should be our first step to incent savings and investment?

Quite simply, restore the tax-deductible IRA. Why?

People need to be encouraged to save. A tax deduction does just that. I remember the flood of IRA contributions we use to receive each year from January to April 15. The people making these contributions were not the rich but rather were people of moderate means who knew the importance of saving for retirement. We saw young people saving in record numbers. They understood the value of setting aside money each year for the future. They understood the benefit of tax-deferred compounding, and each and every year they made the decision to set aside $2,000. They understood that by setting aside $2,000 each year from age 22 to age 65; assuming a 7 percent interest rate; would result in more than a half a million dollars for their retirement. After the tax deduction was eliminated for many individuals, the number of people making contributions dropped dramatically. Yes, they still understood the need to save and the value of compounding tax deferred, but they quite simply needed the nudge that a tax deduction gave them.

We have all seen studies that suggest IRAs are merely a shift of savings. We've also seen the studies that suggest IRAs create new savings. The reality is, the tax deductible IRA probably did not exist long enough to make either argument conclusively. I can tell you from my own experience and from those of our Investment Representatives that more of their clients, particularly younger people, responded when IRAs were tax deductible and responded again when the tax incentive was removed!

I know there are a variety of proposals currently being discussed that will effect IRAs, but our clients tell us offering a tax deduction initially will be a great incentive to save. I also understand the revenue costs of restoring the tax deduction and would suggest that if an up-front tax deduction is not possible that a back-loaded IRA will get us on the right track to encourage people to save for their future.

If an up-front tax deduction is impossible, I suggest a compromise. As people age, saving for retirement becomes more of a priority. Around the age of 45, when retirement is actually no longer a dream but fast becoming a reality, people tend to save more. They don't necessarily need as great of a tax incentive to start saving. Their age is incentive enough. Young people, on the other hand, need a tax incentive to save, so perhaps a solution is to offer a tax deductible IRA for those individuals 45 and younger. After the age of 45, the tax deduction would no longer be available but distributions from the account would be tax free. This form of IRA would incent both groups to save and also minimize the amount of lost revenue.

Edward D. Jones & Co. is committed to helping our clients prepare for a comfortable retirement. Each year we bring a group of our Investment Representatives to Washington, D.C., to express the views of our clients. These Investment Representatives are not paid lobbyists; they work with individual investors, a number of whom are your constituents, and bring to the nation's capital a first-hand knowledge of what their clients want and need. Because of this, for three out of the past four years, this trip has centered on the importance of restoring the tax-deductible IRA. We believe the national interest is served by increasing the amount people save and invest. We believe "A penny saved is a penny earned."

I sincerely appreciate the opportunity to provide this Committee with our views and the views of our clients. I hope you agree it's time to restore the tax deductible IRA to encourage Americans to save.

I'd be happy to answer any questions at this time.

ENDNOTES

1. Securities Industry Trends: An Analysis of Emerging Trends in the Securities Industry; "Retirement Savings: A Time to Act," February 28, 1994.

2. Employee Benefit Research Institute: Issue Brief; "Pension Coverage and Participation Growth: A New Look at Primary and Supplemental Plans;" December 1993.

Mr. THOMAS. Thank you very much, Mr. Bachmann.
Mr. McKee.

STATEMENT OF RAYMOND W. McKEE, SENIOR VICE PRESIDENT AND GENERAL TAX COUNSEL, BANK OF AMERICA, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, WASHINGTON, D.C.

Mr. McKEE. Mr. Chairman and members of the committee, I am Ray McKee, senior vice president and general tax counsel of the Bank of America. I am appearing today on behalf of the American Bankers Association in my capacity as chairman of the association's taxation committee.

I appreciate the opportunity to speak to the committee today to offer the banking industry's support for efforts to revitalize individual retirement accounts. We are particularly pleased that the concept of a tax-advantaged savings vehicle appears to have strong bipartisan support.

As you have been told, the personal savings rate in this country has trended down over the past several decades. According to the Department of Commerce data, the personal savings rate has dropped from an average of 7.8 percent in the seventies to only 4.7 percent in the nineties. This declining trend in personal savings means that individuals will be less well prepared to meet a variety of financial needs they are likely to encounter during their lives; and because savings and investment are critical ingredients in economic growth, a declining savings rate also has negative implications for the future of our economy.

Federal Reserve Board Chairman Alan Greenspan has stated that the single most important long-term issue for this country is inadequate savings. We simply cannot afford to ignore this problem. An increased pool of long-term savings is essential to support job creation, opportunity and economic growth. Clearly, revitalizing IRAs will not solve all of our problems, but it is an important first step toward recognizing that we must provide incentives to encourage individuals to save more for their own good and for the good of the economy.

The challenge then is to develop an appealing IRA to attract a wide range of individuals to participate. To be successful, an IRA must meet three criteria. First, it must be simple enough to be easily understood by consumers; second, eligibility criteria must also be sufficiently inclusive to provide for broad participation; and third, it must be flexible enough to be responsive to the financial needs of today's consumers.

Mr. Chairman, let me elaborate on these three points. First, simplicity.

The rules for determining eligibility for today's IRAs are simply too difficult to understand. Millions of consumers have been so confused about the tests, eligibility determinations and income limitations that many eligible individuals do not participate. We cannot stress too much the importance of simplicity.

Second is eligibility. In 1981, almost all working Americans were eligible to participate, and IRAs became immensely successful. However, the 1986 Tax Reform Act changed the rules to significantly reduce eligibility, and contributions have continued to shrink every year since then. For a tax-favored savings incentive to be effective in generating new savings, the pools of those eligible to participate in the plan should be as wide as possible.

Our third criteria is flexibility. The lack of flexibility is probably the main reason why people have been reluctant to establish IRAs. Individuals are understandably concerned about sinking their money into a totally illiquid account from which funds can only be retrieved at retirement or with significant penalties, or at death. People need a comfort level that even long-term savings can be available for certain important expenditures.

The indexing of contribution limits is another flexibility issue. In 1981, the maximum permissible contribution to an IRA was $2,000 per person, which today is only worth about $1,273. Indexing contribution limits would eliminate the need to adjust the law in the near future.

IRAs should also provide a range of options to the consumers such as offering frontloaded and backloaded alternatives, since individuals' preferences may differ. The American dream savings account is a positive step and has many important characteristics. It is simple to understand, its eligibility requirements provide for a much greater number of participants than current law allows and it is generally flexible with its qualified withdrawal feature and indexing of contributions. Adding the frontloaded choice would make the proposal even more attractive and, hence, more effective in increasing long-term savings.

In conclusion, we support legislative efforts to restore tax-favored retirement vehicles for individuals at all income levels. If IRAs are too complicated to understand, people will be discouraged from participating. If eligibility is limited by income level or dependent on whether an individual is covered by another pension plan, fewer people will be able to use the product. Without flexibility, including the ability to withdraw funds for important purposes without significant tax penalties, savers will be reluctant to put the money aside in the first place.

We urge that legislative efforts to revitalize the IRA be built on these three criteria. We are confident that the result will be a generation of new savings by individuals and a positive impact on the national savings rate.

Thank you for the opportunity to present these views, and I await your questions.

[The prepared statement follows:]

Statement of Raymond W. McKee
on behalf of the American Bankers Association

Before the
Committee on Ways and Means
United States House of Representatives

January 31, 1995

Mr. Chairman and members of the Committee, I am Ray McKee, Senior Vice President and General Tax Counsel of the Bank of America. I am appearing today on behalf of the American Bankers Association, in my capacity as Chairman of the ABA's Taxation Committee.

The American Bankers Association is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA members represent approximately 90 percent of the commercial banking industry's total assets, and about **94 percent of ABA members are community banks** with assets less than $500 million.

I appreciate the opportunity to speak to the Committee today and to offer the banking industry's support for efforts to revitalize individual retirement accounts (IRAs). We are particularly pleased that the concept of a tax-advantaged savings vehicle appears to have strong bi-partisan support.

Mr. Chairman, as you well know, the personal savings rate in this country has trended down over the past several decades. During the 1970s, individuals saved 7.8 percent of their disposable income; in the 1980s, the personal savings rate declined to 6.5 percent; for the first half of the 1990s, individuals saved only 4.7 percent of their disposable income.

This declining trend in personal savings means that individuals will be less well prepared to meet a variety of financial needs they are likely to encounter during their lives -- including buying a home, paying for college, covering medical emergencies and providing an adequate retirement income. And because savings and investment are critical ingredients in economic growth, a declining savings rate also has negative implications for the future of our economy and for our ability to create new jobs.

Clearly, revitalizing IRAs will not solve all of our problems. But it is an important first step toward recognizing that we must provide incentives to encourage individuals to save more -- for their own good and for the good of the economy.

The concept of an IRA is appealing to individuals for their retirement savings, primarily because of the tax incentive. That tax advantage is often viewed as a supplement to savings, making the IRA an appealing product for an individual's long-term savings growth. Individuals who are concerned about the availability of retirement funds can appropriately complement social security and other retirement savings vehicles with IRAs. Once an IRA has been established, the tax implications that accompany early withdrawals provide further encouragement to save for the long-term.

The challenge, then, is to develop a viable IRA product with sufficient appeal to attract a wide range of individuals to participate. We believe that, to be successful, an IRA must meet three criteria:

- first, it must be simple enough to be easily understood by consumers;
- second, eligibility criteria must be sufficiently inclusive to permit broad participation; and

- third, it must be flexible enough to be responsive to the financial needs of today's consumers.

If those criteria are met, we believe that individuals will view the new and improved IRAs as valuable tools for long-term savings, and that the product will be far more successful than the IRA vehicle that is currently available.

Mr. Chairman, let me elaborate on these three points.

SIMPLICITY

One problem that has diminished the effectiveness of the current version of the IRA for bank customers is its complexity. In particular, the rules for determining eligibility for today's IRAs are simply too difficult to understand. Millions of consumers have been so confused about the tests, eligibility determinations, and income limitations, that even when they are eligible, many individuals do not participate in IRAs. The problem has been exacerbated by the changes, and by constant discussions of changes, in IRAs. We cannot stress too much the importance of simplicity. We strongly recommend that any new proposal be simple to understand in its terms and conditions.

We believe that the American Dream Savings Account is simple in its terms, conditions and design, and meets the simplicity test.

ELIGIBILITY

In 1981, almost all working Americans were eligible to participate, and IRAs became immensely successful. However, after the 1986 tax reform act, the eligibility rules were changed dramatically -- individuals covered by private pension plans were no longer eligible and the income limits established ($25,000 for individuals and $40,000 for couples) significantly reduced eligibility. Participation declined dramatically, and contributions have continued to shrink every year since 1986.

Inflation also contributed to the decline in the effectiveness of IRAs. Many in the low to middle income bracket that remained eligible under the 1986 tax reform act have gradually been forced out of eligibility simply because of inflation-based pay increases. Going forward, inflation will continue to shrink the base of those eligible to invest unless some type of indexation is permitted under the statute.

How can tax incentives work to continuously generate new long-term savings if the pool of eligible contributors is steadily shrinking? For a tax-favored savings incentive to be effective in generating new savings, the pool of those eligible to participate in the plan should be as wide as possible.

In the American Dream Savings Account, there are no income limits. Similarly, it does not eliminate those individuals covered by another pension plan. Therefore, a much greater number of individuals and households may participate in this proposed IRA than current law allows.

FLEXIBILITY

If there is any single reason why people have been reluctant to establish IRAs, it is probably the lack of flexibility. Individuals are understandably concerned about sinking their money into a totally illiquid account from which funds can not be retrieved without significant penalties -- except by crossing the retirement age threshold. For a savings incentive to work, people need to have a certain comfort level that their savings can be accessed for emergencies and for certain other important expenditures of their lives.

In our opinion, the provisions in the American Dream Savings Account offer that flexibility and will eliminate much of the anxiety that younger investors experience when they consider putting their money into what is perceived, by some, as almost a lifetime investment.

Another flexibility issue that may be important over time is the indexing of contribution limits. In 1981, the maximum permissible contribution to an IRA was $2,000. However, that $2000 is only worth $1273 in today's dollars. A plan that protects the contribution limits from such erosion by the effects of inflation may be desirable so that the maximum contribution will not need to be adjusted by law in the near future.

The American Dream Savings Account includes this indexing feature for contribution limits.

We also believe that a plan should be flexible in offering a range of options to the customer. Many of the current savings proposals differentiate between whether the IRA is "front-loaded" or "back-loaded". With a front-loaded IRA, the taxpayer may take a tax deduction for the amount of the contribution. Alternatively, with a back-loaded IRA, there is no tax deduction for the contribution; instead, all earnings and contributions from the investment can be withdrawn tax-free for qualifying expenditures. A tax-favored savings plan should be flexible enough to offer both options to customers, since the decision as to which plan would be preferred may differ among individuals.

The American Dream Savings Account offers individuals the back-loaded choice only. We think that opening up the options to allow for the front-loaded choice would make the proposal even more attractive and, hence, more effective in accomplishing the desired goal of increasing long-term savings.

ECONOMIC BENEFITS OF AN EXPANDED IRA

By following our suggested criteria -- simplicity, eligibility, and flexibility -- we believe that a new IRA product will be successful in increasing individual savings and will benefit the economy as a whole. A properly designed retirement savings instrument will result in higher usage by individuals and more long-term savings.

There is general agreement that the level of national savings in this country has reached historic lows. Federal Reserve Board Chairman Alan Greenspan has stated that the single most important long-term issue for this country is inadequate savings. Savings promote capital formation, which is essential for job creation, opportunity and economic growth.

Today's low savings rate suggests that people are not preparing adequately for the future. A recent study by Merrill Lynch looked into the question of whether the baby boomer generation was saving enough to be adequately prepared for retirement and found that it was not. In fact, that generation is only saving one third of what it should be saving. In other words, the typical baby boom household should triple its rate of savings to be adequately prepared for retirement.

The study goes on to suggest that this statistic is probably greatly underestimated since many will have to use retirement savings to pay for purposes other than retirement, such as increased costs of health care and long-term care for the aged, compounded by the reality that people are living longer.

To help address concerns about the inadequate level of savings by individuals, today's IRAs must be updated. The American Dream Savings Account is a positive step toward creating a useful IRA product. It has many of the characteristics that we believe are important to attract individuals to contribute to IRAs.

CONCLUSION

In conclusion, we support legislative efforts to restore tax-favored retirement vehicles for individuals at all income levels. In order to encourage people to return to a routine, long-term savings plan, we need an attractive product that meets the tests of simplicity, eligibility, and flexibility.

If the rules for IRAs are too complicated to understand, people will be discouraged from participating. If eligibility is limited by income level or dependent on whether an individual is covered by another pension plan, fewer people will be able to use the product. Without flexibility, including the ability to withdraw funds for important purposes without significant tax penalties, savers will be reluctant to put money aside.

We urge that legislative efforts to revitalize the IRA be built on these three criteria. We are confident that the result will be the generation of new savings by individuals and a positive impact on the national savings rate.

Thank you for the opportunity to present these remarks. I will be happy to answer any questions you may have.

Chairman ARCHER [presiding]. Thank you, Mr. McKee.
Mr. Buchert.

STATEMENT OF JAY BUCHERT, PAST PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, D.C.

Mr. BUCHERT. Thank you, Mr. Chairman. I am Jay Buchert, a homebuilder from Cincinnati, Ohio, and past president of the National Association of Home Builders. It is a pleasure to be here today to represent the 180,000 small firms which are located throughout the country that make up the National Association of Home Builders. We applaud the Chairman's willingness to hold these hearings and appreciate the opportunity to be here today.

Mr. Chairman, homebuilders have been long-term supporters of many of the proposals contained in the Contract With America. In fact, we just, at our convention in Houston, Tex., Chairman Archer's hometown, passed a resolution overwhelmingly supporting the Contract.

We are particularly proud of our long-term support for Chairman Archer's capital gains proposals, and we thank him for his continued effort in that area over the years.

My testimony here today will address the tax provisions of the Contract, which we fully support, and my oral statement will be limited to the American dream savings account.

Mr. Chairman, we support the use of IRA deposits for the downpayment on a first home, and respectfully suggest a simple modification of this provision to better accomplish its stated purpose. Downpayment and closing costs are still the primary barrier for young people in the purchase of a first home. Even with low downpayment requirements under lending programs such as FHA, the GSEs and the Federal Home Loan Bank System, it is still difficult for young households to accumulate the cash needed to make that first step toward home ownership, considering the small amounts that they have in their IRA accounts, repayment of their student loans, financing an automobile and the cost of starting a family. I witness this situation personally time and time again as young people attempt to make the important leap into home ownership while visiting my subdivisions in Cincinnati, Ohio.

May I suggest, to maximize the investment of IRAs, the proposal be modified to allow withdrawals of parents and grandparents from their IRA accounts in the form of a loan. This alternative should be treated as an investment for their tax-deferred account rather than a penalty-free withdrawal.

Mr. Chairman, NAHB estimates that this alternative provision would generate annually an additional 36,000 first-time home purchases and an additional 20,000 jobs that will accompany those purchases.

Mr. Chairman, the premise that there is a cost to this alternative of the IRA investment, we feel is unfounded. The premise assumes that parties using this provision would otherwise be cashing in portions of their IRAs and paying either the taxes or the penalties. We feel that that is very unlikely. We see this provision as an alternative investment with little effect on the Federal Treasury.

Mr. Chairman, I would like to discuss further this proposal in the question and answer period. I would like to thank the members of the committee very much for our opportunity to make these recommendations, and we look forward to working with you and your staff on these and other issues in the coming years.

[The prepared statement follows:]

**TESTIMONY OF THE
NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
JANUARY 31, 1995**

Mr. Chairman, members of the committee, my name is Jay Buchert I am a home builder from Cincinnati, Ohio and am a past president of the National Association of Home Builders. On behalf of the National Association of Home Builders (NAHB) and its 180,000 members, I congratulate you for holding this hearing and appreciate the opportunity to appear here today. At the outset, let me state that NAHB has long been supportive of many of the proposals contained in the Contract with America. We are particularly proud of our long-standing support of your capital gains proposals, Mr. Chairman, and we thank you for your continued efforts throughout the years.

OVERVIEW

The Contract with America's provisions contain a number of proposals and ideas which NAHB has supported and advocated over the past few years. Specifically, the tax and penalty-free use of IRA funds for first-time home purchase, reinstatement of a capital gains rate differential, clarification of the home office deduction rules and other small business incentives have been a part of the established policy of NAHB for quite some time. Our testimony here today will address those specific proposals and offer our suggestions for improvement, where appropriate.

AMERICAN DREAM SAVINGS ACCOUNTS

NAHB supports expansion of tax-deferred retirement savings and use of IRA deposits for down payment on a first home. The proposal currently before the committee would create a new IRA (American Dream Savings Accounts), and allow the tax and penalty-free distribution of funds from that account for first-time home purchase. NAHB supports this legislation and suggests modification of its provisions to better accomplish its stated purposes.

Accumulating the downpayment for the purchase of a first home is the primary barrier to home ownership for many young households. Even with lower downpayment requirements under FHA and special affordable housing programs from Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, first-time home buyers find it difficult to accumulate the cash necessary to make the leap into home ownership. The U.S. Census Bureau and the Harvard Joint Center for Housing Studies have recently reported that down payment remains a serious barrier to home ownership for young renters.[1] Approximately nine-out-of-ten young renters cannot afford to purchase even a modest home in their area.

Increasing housing costs add to the housing affordability problem in this country. From World War II until 1980 homeownership rates in the U.S. increased. Since that time homeownership rates overall have declined. Particularly hard hit are those in the prime home buying age of 25-34. The homeownership rates of those in the age group 25-29 dropped from 43.3% to 34.6% and those in the 30-34 age group dropped from 61.1% to 51%. This trend is of significant concern.

Homeownership Rates (Percent)

Age	1980	1983	1986	1990	1993
25-29	43.3	38.2	36.1	35.9	34.6
30-34	61.1	55.7	54.1	51.5	51.0
35-39	70.8	65.8	64.2	63.1	62.9
40-44	74.2	74.2	69.3	70.4	68.7
45-54	77.7	77.1	75.6	76.1	75.2
55-64	79.3	80.5	81.0	80.4	79.6
65-74	75.2	76.9	77.6	78.7	79.9
75+	67.8	71.6	70.3	71.0	74.0

There are many factors that contribute to the housing affordability problem we are facing in this country. Certainly a factor has been increasing housing costs. Higher mortgage interest rates and general economic inflation have also been factors. The National Association of Home Builders believes government over-regulation is a significant contributor to increased land development and housing costs. The Kemp Commission on "Removing Barriers to Affordable Housing" identified numerous government regulations that add to the problem. We strongly urge Congress to make an aggressive review of these regulations and eliminate or change those that are unnecessary, costly and counter productive.

WHY IT IS IMPORTANT TO PROMOTE HOME OWNERSHIP

NAHB urges Congress to pass the American Dream Savings Act to create an incentive which will promote savings and encourage homeownership. Mr. Chairman, your American Dream Savings Act will make it possible for thousands of young working families to obtain the American Dream of homeownership. In turn, the construction of their homes will create jobs and the expansion of our economy. Equally important the expansion of homeownership contributes to the social/political stability of our society.

HOUSING - ITS ECONOMIC IMPACT

Housing construction contributes jobs, taxes, and economic activity to the U.S. economy. Each year, nearly 3 million jobs are created in the construction of new homes. These jobs create $78 billion in wages and $ 44 billion in federal, state and local taxes on that wage and business income. Even greater economic activity is created as the income generated in the construction, manufacturing, and sales jobs spread throughout the rest of the local economy.

NAHB estimates that housing, including new construction, remodeling, repairing and maintenance, and the value provided by existing homes accounts for 13 percent of the U.S. economy. This on-going benefit provides most American home owners and renters with decent, safe affordable housing.

		Single Family		Multi-family	
Industry Group	**Avg Annual Wage**	**Number of Workers**	**Wages (1,000s)**	**Number of Workers**	**Wages (1,000s)**
All Industries		2,097	$60,495.0	800	$23,297.3
Construction	$29,222	1,194	34.901.1	453	13,237.6
Onsite	29,222	1,015	29,660.3	398	11,630.4
Offsite	29,222	179	5,230.7	55	1,607.2
Land Development	29,222	100	2,922.2	50	1,461.1
Other Industries		803	22.681.7	297	8,598.7
Mfg	32,370	335	10,844.0	152	4,920.2
Trade, Transp, and Services	26,808	261	6,996.9	84	2,251.9
Mining	23,386	207	4,840.9	61	1,426.5

HOMEOWNERSHIP - IT'S IMPACT ON OUR SOCIETY

Homeownership truly is a fundamental part of the American Dream. Getting a good education, working hard, practicing thrift so that home ownership can become a reality, has been a motivating force for millions of Americans. NAHB's surveys show that 80 to 90 percent of all Americans want to become home owners. Recent studies by Fannie Mae have demonstrated the goal for home ownership is strong among all age and income groups. We believe that a goal seeking, motivated population is an essential element of a stable, productive society.

Homeownership not only allows families to establish roots in their communities, but it strengthens neighborhoods, expands participation in civic, religious, and community activities. It is what ties our neighborhoods together.

Homeownership provides financial security. It is the largest single asset of most Americans. For millions it represents a nest egg for retirement which has provided the elderly a strong supplement to social security. Many point to the low rate of per capita savings in the United States. However, if the equity in the homes of individuals were calculated, our per capita savings rates would be dramatically higher.

Homeownership also is the tax base for our public schools and community services. It provides a safe haven, a sanctuary, a secure place for families to live, grow and prosper. This environment is essential for the development and growth of our children. How can a child study properly, develop family values, excel and expand their goals and dreams without the proper environment? Homes are what provide that secure, protected and nurturing environment for millions of Americans. We should strive to do what is possible to provide this opportunity, homeownership, for more young families, and that Mr. Chairman is what the American Dream Savings Account will do.

IRA SAVINGS FOR DOWNPAYMENT

IRAs could be a useful resource to assist in first-time home purchase. IRAs already have substantial deposits. Total assets held in IRAs and Keogh plans (retirement plans for the self-employed) reached $773 billion at the end of 1992. Another $230 billion is invested in salary reduction plans (401(k), 457 and 403(b) tax deferred employer and employee contribution retirement plans) and $304 billion is invested in the federal government retirement plan for civil servants[2]. Collectively, these retirement plans could provide up to 1.3 trillion dollars.

Current Proposals. A number of proposals have been made to increase the potential use of retirement accounts for first time home purchase down payments. Proposals for use of existing "front-end" accounts typically propose penalty-free withdrawal of funds from the IRA for specified purposes. However, the tax that was deferred when the deposit was originally made must be paid at the time of withdrawal. Accordingly, withdrawal would be relatively expensive, especially if the funds were deposited at a time when the taxpayer's marginal tax rate was lower.

In this connection, we commend to your attention a bill entitled the "Savings and Investment Incentive Act of 1995", S. 12, introduced by Senators William Roth (R-DE) and John Breaux (D-LA). That bill would restore the IRA deduction and adjust the $2,000 deductible amount for inflation. It would also create nondeductible tax-free IRAs called "IRA Plus" accounts. Under the provisions of S. 12, distributions may be made free of penalty if used for first-time home purchase by the individual, their spouse, child, grandchild or ancestor.

The American Dream Savings Account (ADS) would provide an incentive to use IRA funds for a first-time home purchase. However, as currently crafted, the proposal's impact on home ownership would be minimal. The proposed ADS rules would require that the funds be maintained on deposit at least 5 years prior to withdrawal. First time home buyers are typically in their early 30s and currently have small account balances in tax-deferred retirement accounts. The long waiting period coupled with the first-time purchaser's paucity of funds defer and diminish the stimulative impact of the proposal. Although the ADS would increase the incentive to save, resulting in greater participation, the likelihood of generating substantial savings is small.

NAHB suggests that the ADS proposal be modified to allow home purchase withdrawals to be made from parents and grandparents accounts and that the waiting period be eliminated for first-time home purchase. The reason that this is important is because the very individuals this is targeted to assist, those young working families that are recently out of college trying to pay off student loans, or finance a car, have precious little left over for a retirement account.

Program Design. In designing a successful proposal for using retirement funds for down payments, there are three important components: 1) The use must be considered an alternative investment rather than a withdrawal; 2) Eligibility must be open to parents and grandparents of first time home buyers as well as the buyer; and 3) Eligible plans must include IRAs, Keoghs, 401(k) and other salary reduction plans, and the federal government retirement system. In the alternative, an attractive and economical proposal would allow down payments for first home purchase to be treated as an **investment** for tax deferred accounts rather than as a penalty-free withdrawal. Withdrawing the funds also subjects the taxpayer to implicit penalties in that the account holder's investments in tax deferred assets are reduced. From the point of withdrawal on, interest on withdrawn funds would be taxed at current marginal tax rates, again often higher than those anticipated during retirement. Treating the down payment as an alternative investment would avoid both explicit and implicit penalties.

The ability to use tax deferred retirement accounts for a down payment must be open to parents and grandparents because few young people have sufficient retirement savings to be useful. Table 1 shows participation rates by age of employee in employer pension plans. Table 2 shows account balances by age for salary reduction plans, chiefly 401(k) plans. Employees between 25 and 30 years old have the lowest participation rate in retirement plans and an average account balance of $5,185. A 10 percent down payment and associated closing costs on a median priced existing home sold would require cash in the amount of $13,000[3].

On the other hand, the parent of a potential first time home buyer is at least 45 years old, with an average IRA balance of approximately $16,380. Grandparent IRAs are most likely to have sufficient balances to provide down payment support in that workers between 60 and 64 years old have average IRA balances of $25,011.

Under current law, IRAs are primarily alternative forms of retirement savings when the saver's employer does not offer a retirement account, the saver is not self-employed, or the saver's income is under $40,000. About 20 percent of all workers have IRAs compared to 53 percent who participate in some employer pension plan. In order to have any significant impact, the first-time home purchase provision should also apply to other retirement accounts.

Expanding the eligible investments of a tax deferred retirement account to include qualified first time home purchases will have very little impact on federal tax receipts in the near term. The transfer of funds across investment opportunities is already a frequent occurrence and has no federal tax implications. The ability to use retirement funds for first time home buyer assistance may increase the desirability of saving in this form, both for potential first time home buyers as well as their parents and grandparents. Any increase in tax deferred savings because of the expanded options would decrease federal tax revenues over a longer period of time as deposits increased.

Table 1
Participation in Employer Pension Coverage

Age	Percent of All Workers Who Participate
25 - 30	40.9
31 - 40	53.3
41 - 50	62.6
51 - 60	60.0
61 - 64	54.2
65 & Up	27.5
All	53.3

Source: Employee Benefit Research Institute, Issue Brief, December 1993, p.5.

Table 2
Average Account Balance
Among Salary Reduction Plan
Participants

Age	Average Balance
25 - 30	$5,185
31 - 40	$10,207
41 - 50	$16,380
51 - 60	$20,456
61 - 64	$25,011
65 & Up	$13,953

Source: Employee Benefit Research Institute, Issue Brief, December 1993, p.18.

In this regard, we recommend that such use (by either the buyer, parents or grandparents of the buyer) be deemed an eligible investment of the IRA. Roughly 15 percent of potential first-time home buyers have invested in IRAs and another 9 percent have invested in 401(k) plans [4]. NAHB estimates that allowing a first-time home buyer's purchase to be a qualified investment within the plan would create 20,000 jobs and generate 36,000 additional home purchases.

CAPITAL GAINS

The Contract would provide three capital gains incentives: (1) a 50 percent capital gains reduction, (2) indexation of the basis of capital assets to eliminate inflationary gains, and (3) a capital loss deduction for homeowners.

NAHB supports reinstatement of a capital gains rate differential for real estate and other assets and their indexation for inflation. More favorable capital gains treatment would not only encourage purchases of existing properties, but would also encourage investment in new construction, rehabilitation and remodeling. It would also reduce required rents on new construction. For example, taxation of capital gains at 50% of ordinary income rates would eventually reduce all rents by 5%. This represents a tax cut for the middle class and those struggling to become middle class. Yet another example of why a capital gains tax break is not for the wealthy.

NAHB believes that taxation of assets held for one year or more at a lower rate than ordinary income encourages investment and savings. However, taxation of realized gains on long-held assets at ordinary income rates (i.e. on sale or transfer) reduces the economic incentives to invest in the most efficient, highest return opportunities. Removal of the retardant effect of current law taxation would allow taxpayers to place their capital in the most promising sectors of the economy. More efficient capital flows would create jobs and stimulate the economy.

A capital gains tax cut would not benefit only higher income taxpayers. One-half of the 1991 tax returns claiming a capital gain or loss reported incomes below $60,000. Furthermore, encouraging investment through reduced taxes on the gains from that investment would create jobs and economic activity at all levels of income.

With respect to real estate, a capital gains preference would increase investors and owners incentives to purchase, rehabilitate and operate rental housing. Part of the total return to investors who own rental housing is property appreciation. The greater the owners after-tax income from the appreciation portion of their return, the less income required from rents to achieve the same earnings. Reducing capital gains tax rates will reduce residential rents. Since much of the appreciation in housing is due to price inflation, adjusting the gains for inflation will reduce rents even more.

We must insist however, that any capital gains incentive include real estate. Just as real estate served as the engine to lead the economic recovery, so it must be included in any capital gains reduction in order to maximize the dynamic economic impact of the proposal. Indeed, inclusion of real estate effectively rebuts any argument that a capital gains tax cut would favor only wealthy taxpayers. Mr. Chairman, I know this has been a long standing position of yours.

The capital loss deduction provision would allow taxpayers to get out of homes that have fallen in value. For taxpayers who may be hesitant to move to another dwelling, the provision would help to soften the financial repercussions of taking the loss on their current home. NAHB supports allowance of a capital loss deduction for sale or disposition of a principal residence.

HOME OFFICE DEDUCTION

The United States Supreme Court's Soliman decision effectively eliminated the home office deduction for the real estate construction industry. NAHB fully supports the proposal to clarify the standards for claiming a tax deduction for maintaining an office in the home.

Home building is dominated by small firms, many of which use home offices as their primary administrative location for doing business. Eighty percent of NAHB's builder-members construct fewer than 25 homes a year and most of these firms do not maintain a separate office. Many operate out of their homes, making necessary contacts with subcontractors and customers, and where, very often other family members assist in the administrative and clerical duties of the business.

The Contract proposal will help reduce housing costs by reducing builder/remodeler's costs. Because of the highly competitive nature of the construction business and the number firms available to perform services, the reinstatement of the home office deduction will translate into lower house prices. For an average builder who constructs 10 homes a year, and uses his home as the center of operation, the savings could be several hundred dollars per home.

INCREASED DEPRECIATION DEDUCTIONS AND NEUTRAL COST RECOVERY

NAHB supports adjusting real estate depreciation to account for inflation.

The Contract would allow taxpayers to adjust real estate depreciation amounts to reflect inflation. The inflation adjustment would put depreciable assets on an equal footing with expensed items. Currently, a business that purchases a piece of depreciable machinery can deduct a certain percentage of that machine each year, based on the principle that each year some of the machine is "used up". However, as inflation further erodes the value of the capital asset, the residual value of the asset is lessened. Expensed items, on the other hand, because they are purchased in the year of deduction, already reflect inflation.

Inclusion of real estate in the neutral cost recovery provision is particularly important in that the straight-line depreciation periods are long, and more directly impacted by inflation. Further, real estate can not be "expensed" as with business equipment.

INCREASE IN UNIFIED ESTATE AND GIFT TAX CREDITS

As pointed out above, home building is dominated by small firms which very often are family owned and operated. The current estate and gift tax laws operate to destroy family-owned businesses by imposing a tax upon the inter-generational transfer of the business. Moreover, the economic impact of the tax increases from year to year because of inflation. NAHB fully supports increasing the amount of the unified credit to $750,000 and indexing that amount for inflation.

CONTRIBUTIONS IN AID OF CONSTRUCTION

As the Contract moves towards passage, there may be some opportunity to include additional provisions in the tax package. In that event, NAHB would urge that you amend the Internal Revenue Code to remove the tax on contributions-in-aid-of-construction. NAHB considers this to be a "tax" levied on home builders and, in-turn, home purchasers.

As you are no doubt aware, the 1986 Tax Reform Act repealed Internal Revenue Code section 118(b) with respect to corporate regulated utilities. The tax imposed on utility companies is grossed-up and passed on to developer-builders who must increase the cost of each home to cover this cost. The additional amounts resulting from CIAC adds from $2,000 to as much as $5,000 to the cost of each home sold, depending on the area of the country affected.

MORTGAGE INTEREST DEDUCTION

NAHB would strongly resist any tampering with the mortgage interest deduction, which we maintain is the cornerstone of housing policy and the principal government policy that changed this nation from one of renters to one with 65% home ownership.

Conclusion

For the reasons stated above, the National Association of Home Builders believes that the proposals contained in the Contract with America would be beneficial to the home construction and remodeling industry. The Contract would provide much needed tax relief and begin to bring the Internal Revenue Code into accord with economic reality and taxpayer fairness. As we have stated, we suggest that certain proposals be modified to have a more meaningful and immediate impact.

Once again Mr. Chairman, NAHB thanks you for this opportunity to present our recommendations. We look forward to working more closely with you and your staff in the coming years.

END NOTES

1. *The State of the Nation's Housing 1993*, Joint Center for Housing Studies of Harvard University and *Who Can Afford to Buy in House in 1991*, Current Housing Reports H121/93-3, Bureau of the Census.

2. Employee Benefit Research Institute, EBRI Notes, November 1993 and Issue Brief, December 1993.

3. The median existing home sales price for the first half of 1993 was $106,000 and closing costs for an FHA loan are about 2.5 percent of the mortgage amount. Hence, cash required is $10,600 for the 10 percent down payment and $2,456 for closing costs on a 90 percent mortgage plus the 3 percent up-front insurance premium.

4. "Down Payments for Retirement Accounts", Housing Economics, March 1991.

Mr. THOMAS [presiding]. Thank you very much, Mr. Buchert.

I thank all of the panel. Does any member on the majority side wish to inquire?

Mr. Collins.

Mr. COLLINS. Mr. Chairman, I really don't have any questions for the panel, but we sure do appreciate your taking the time to come here in support of this effort, in support of trying to increase the savings across this Nation. We all feel like that is something that we must do if we are going to have the capital needed for investments.

Mr. THOMAS. Thank you very much.

Ms. Dunn.

Ms. DUNN. Mr. Chairman, thank you. I would just make the same remark and underscore what Mr. Collins said and also let you know, panel, that it is not that we don't have any questions, it is that we agree with almost everything you have said. Thank you for coming.

Mr. THOMAS. Thank you.

I do have some questions. As a person who has been involved for a long time with IRAs in previous Congresses, I want to get your reaction to an idea that we have been discussing. I found several of your testimonies interesting because you are beginning to focus on the fact that over a wide age group, the same program may not be as useful a tool, and you might want to structure it for different age groups.

I had, from the very beginning, a provision allowing withdrawals—that is why we call it the super IRA—for a number of reasons, not only first-time home buying, but also the ability to assist a child or grandchild in purchasing the home. In recent discussions, we focused on the fact that if you were more elderly, if you simply created an ability to fund a child or a grandchild, this would in essence be passing that wealth down a generation, and making you less well able to take care of yourself, and therefore, potentially more of a burden on society.

Have any of you discussed or thought about the idea that below a certain age level—and I don't know whether it would be 50 or 55, but it would have to be around there in terms of generating a young person who is of a home buying age themselves—that you could follow the historic pattern and allow that money to be used; but above, say, age 50 or 55, that it would be required to be in a loan structure, rather than an outright gift, so that the younger person would have an obligation to pay back that portion, and therefore, assist in old age, which is one of the main reasons for an IRA?

Any discussion by any of you about the idea of making that home purchase available above a certain age of the IRA recipient into a loan?

Mr. BUCHERT. Mr. Chairman, we have had discussions at NAHB along that line, just to address the particular situation that you brought up and the concern of many that you are diminishing the ability of the elderly, if they are giving it away to their grandchildren, because many of them are very generous—I know my parents are with my children and the other eight grandchildren that they have through my two sisters.

I think you are right. I think it solves that problem, and it is a reasonable approach. And it is also a good assumption that that is exactly what would take place.

Mr. THOMAS. OK. Let me ask you then a more difficult question.

All of you are in favor of creating incentives for people to put money away for various uses, one of which is home buying, and I think I understand that and I am trying to get a relative worth of this kind of a vehicle.

Mr. Buchert, you testified that you didn't believe the revenue estimates. I have difficulty, as I said earlier, in terms of short-term versus long-term payouts and the rest. But the powers that be tell us that certain styles of IRA, principally the frontload, do cost money in the short run. I am looking for relative worth of this product versus other products in the Tax Code.

Would any of you be supportive of a modest or appropriate reduction in the mortgage deduction level, from the $1 million down to a lower level, to fund the offset for the creation of the IRA; or is the mortgage far more valuable than the IRA? That is a tough question, I know, but frankly, those are the kinds of decisions that we are going to have to be dealing with in terms of tradeoffs in a given area. I would just like to know, if you are able to react, or if your associations will allow you to react to that kind of a tradeoff.

Mr. REID. That is a good question you are asking.

Mr. THOMAS. Mr. Reid.

Mr. REID. I think the income tax deduction for home ownership needs to remain intact, but I think there are maybe some other ways we can look. I think in our proposal we talk about a $500-per-child tax deduction, and I think that that might be something that should be considered as a tradeoff for the IRA situation to go through.

Mr. THOMAS. Thank you very much.

Any other volunteers?

Mr. BUCHERT. I think we also agree that it is a very good question, but a legitimate question. First I would like to respectfully submit that I have two college-age children—well, two out of college and one in college and one in high school now; and my wife and I have an IRA, and for all of the reasons previously mentioned, we haven't contributed to the IRA since the change of the Tax Act. We have just gone about doing things differently. And I think it is just two accounts that are set aside as far as we are concerned at our age, which is the early fifties.

I think the premise that we would cash in that money or cost the Treasury money, or I mean—excuse me, cost them—or pay, for example, a penalty in taxes is unfounded. However, if we thought we could help our four children over the next 5 or 10 years get into a home, which we think would be important, even in the form of a loan where they would have to pay it back, there really wouldn't be any cost.

I think the idea of people saying, oh, I will just go ahead and cash this in or do something different isn't really going to happen. So the legitimacy of the idea of addressing the mortgage interest deduction, it has been the cornerstone of home ownership in this country for years. You know, you work hard, you get a good education, you buy a home for your family. It has made stable communities and it has brought society together and it has really been what has made us what we are. The idea of tampering with that begins to, I think, fly in the face of that whole premise.

I know there is even a provision—they say, well, how about second homes? A lot of people think that second homes, for example, are just for the people who appear on "Lifestyles of the Rich and Famous." The truth of the matter is, I was making a list up earlier today. When you take a look at my State, Ohio, most second homes are in the north along the lake, Lake Erie, and they are also in the same place in Michigan. You know, second homes are in the Poconos in Pennsylvania, they are in the Cumberlands in Kentucky, they are on lakes in Minnesota and Wisconsin. They aren't all in Palm Springs and also in Hilton Head.

Those second homes affect those communities. You know, most of them are owned—because we are builders, and we produce them—by blue collar workers who have looked at them as an investment, as a place for them to live under retirement, as a place for them to take their family while their family is still with them. And then the effect of those homes in each of these communities, whether they be in Gatlinburg, Tenn., or wherever they are, those second homes bring employment, bring stability and bring really the base—economic base that those communities need to exist too.

So I think once we begin to tinker with the mortgage interest deduction, we are beginning to tinker with something that has really been sacred and has really made this whole concept.

I know when I watch young people try to qualify—and I don't sell large custom homes; I sell production-type homes to mainly first-time buyers and young couples. When I watch them sit and tick down through what it takes to qualify, that mortgage interest deduction is very, very important; and I think once we begin to eat away at it, we have done a disservice. Because the inflation I have seen in my 50-some years, you know, I can imagine what it is going to be; and some day we are going to hit that ceiling that we think is so high.

You know, I started out building $19,000 houses and today, who would have imagined we would build half-a-million-dollar and million-dollar houses on a regular basis in most of the communities we live in.

Mr. THOMAS. I thank the panel.

The point you didn't make that I think we need to stress is that it would not be a dollar-for-dollar exchange because the super IRA would allow for a number of other activities, including medical college education, as was expressed earlier by the Senators, so you wouldn't get a dollar-for-dollar exchange.

I just wanted to test the waters. I thank the panel very much.

I would ask that the next panel come forward—Manuel Mehos, Paul Yakoboski, and James E. "Tom" Sawyer.

I will tell the panel that, without objection, your entire written testimony will be made a part of the record, and that you may be able to proceed for 5 minutes' time in any way you see fit to inform the panel. And once again I will start from my right and move to my left.

Mr. Yakoboski, you have 5 minutes.

STATEMENT OF PAUL J. YAKOBOSKI, RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, D.C.

Mr. YAKOBOSKI. Thank you very much. I am pleased to appear before you this afternoon to discuss the ADSA proposal. My name is Paul Yakoboski. I am a research associate at the Employee Benefit Research Institute, a nonprofit, nonpartisan, public policy research organization based here in Washington.

EBRI has been committed since its founding in 1978 to the accurate statistical analysis of economic security issues. Through our research, we strive to contribute to the formulation of effective and responsible health, welfare and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

The ADSA proposal creates a new type of less-restrictive individual retirement account. While this proposal creates a new savings vehicle for individuals to utilize, I would like to raise a few issues for consideration by the committee. One is the implication of such a saving vehicle for retirement income security, and more fundamentally, whether the objective of ADSAs is increased retirement saving or increased savings in general.

If the objective is increased savings in general, the question to be asked then regards the degree to which individuals are likely to utilize the newly created vehicle, and this then feeds into the question of whether it would generate additional savings. The longer the investment horizon of an individual, the more attractive will be saving through an ADSA.

For example, an individual in the 28 percent tax bracket saving $2,000 a year for 5 years, say, toward a downpayment on a first home, would have $600 more in an ADSA than if he saved on a non-tax-deferred basis; I am assuming a rate of return of 6 percent annually. However, given that the ADSA account cannot have a balance that falls below $1,000 with a distribution, he would actually have $400 more at his disposal by saving outside the ADSA.

Take the same individual now saving at the same rate for 18 years instead of 5, say, in this case, for a child's education. He would have $65,500 in the ADSA, compared with $55,100 by saving on a non-tax-deferred basis. Given the above, it is not clear how advantageous someone with a relatively short savings horizon would actually find such a savings vehicle. But an investor with a longer saving horizon is likely to find it very attractive.

If, on the other hand, the objective is increased savings for the purpose of retirement income, the proposal does increase the incentive to save for retirement through an IRA-type of vehicle by allowing the individual access to the money before retirement should it be needed for qualified purposes.

Over 90 percent of those eligible to utilize a tax-deferred IRA choose not to do so. It is often speculated that this is due to a lack of money and a reluctance to put savings in a vehicle where it is beyond one's reach without significant tax penalty should it be needed before retirement. The ADSA proposal would ease such concerns by allowing access to the money after 5 years for first-time home purchase, education expenses or medical expenses. This should result in increased IRA participation through ADSAs. But again, the question is by how much, given that the money is locked up for 5 years and then only accessible for certain purposes.

Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA. Income tax would be paid on the rollover amount at the time of rollover, the future earnings would accrue tax free and any distribution would not be taxed if used for a qualified purpose. Such rollovers would be permitted whether the source of the IRA money was regular tax-deductible contributions, or the rollover of a lump sum distribution from an employment-based retirement plan such as a 401(k). This means that literally hundreds of billions of dollars in retirement savings would be eligible for rollover into ADSAs.

Over the period 1977 to 1992, almost 120 million tax filers claimed a deduction for IRA contributions and the amount claimed was over $252 billion. IRA rollovers are even more significant. In the 4-year period, 1987 through 1990 alone, there were over 11 million rollovers totaling $220 billion.

For some individuals, the tax gain from such a rollover would create a strong incentive to take advantage of the opportunity. However, none of the money rolled over would represent new additions to savings; it would all merely be a shift of existing savings from IRAs to ADSAs. These rollovers would generate tax revenue for the government at the time of a rollover, but would mean less tax revenue in the future.

Under the proposal, significant sums of money that have been accumulated in a tax-deferred vehicle earmarked for retirement would become available for other purposes. This would represent a dramatic change in policy objectives which should be recognized and understood in evaluating the proposal.

Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL J. YAKOBOSKI
RESEARCH ASSOCIATE
EMPLOYEE BENEFIT RESEARCH INSTITUTE
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 31, 1995

I am pleased to appear before you this morning to discuss the proposal for creating American Dream Savings Accounts (ADSAs) found in H.R. 6. My name is Paul Yakoboski. I am a research associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

The American Dream Savings Account proposal creates a new type of tax-preferred saving vehicle for individuals. As proposed, an ADSA is a less restrictive type of individual retirement account (IRA).[1] Anyone may make a contribution of $2,000 annually, irrespective of income or pension participation status. The contribution is with after tax dollars, but investment earnings accrue tax free subject to conditions. All distributions from such an account are tax exempt if they occur at or after age 59 1/2 or the account has been open for at least five years and the distribution is used for first time home purchase, education expenses, or medical expenses.[2,3] Furthermore, money in an existing IRA (whether the result of regular tax deductible contributions or of the rollover of a lump-sum distribution from an employment-based plan such as a 401(k)) would be eligible for rollover into an ADSA.[4] Income tax would be paid on the rollover amount at the time of rollover, but future earnings would accrue tax free and any distribution would not be taxed if qualified as outlined above.

While this proposal creates a new option for individuals to utilize in saving, both for retirement and other designated purposes, I would like to raise a few issues for consideration by the committee. One is the implication of such a saving vehicle for retirement income security, and more fundamentally whether the objective of ADSAs is increased retirement saving or increased saving in general?

Assuming for the moment an objective of increased saving in general, a question to be asked then regards the degree to which individuals are likely to utilize the newly created vehicle and this feeds into the question of whether it would generate additional saving. If an individual were to save $2,000 a year for five years on a nontax preferred basis, say toward the down payment on a first home, he would have $11,400 (assuming a 6 percent rate of return and a 28 percent tax bracket). If the same saving was done through an ADSA, the individual would have $12,000 at the end of five years in his account, a gain of $600. The question then is whether such gain is sufficient incentive for individuals to tie up their money in an ADSA? If the money is needed before five years, it would be inaccessible without tax penalty. In addition, the individual could actually withdraw only $11,000 from the ADSA since the account balance is not allowed to fall below $1,000 with a withdrawal.[5] Therefore, more money that can actually be used toward a down payment would be available by saving outside the ADSA ($11,400) than within the ADSA ($11,000) in this instance.

However, with a longer investment horizon, such as one may have when saving for a child's college education, the financial advantage of saving through an ADSA would increase. Assume an individual again saves $2,000 per year, only now he saves this amount for 18 years. (Again, he is in the 28 percent tax bracket and earns a rate of return of 6 percent.) In this instance, the individual would have $65,500 in the ADSA after 18 years, compared with $55,100 by saving on a non tax-preferred basis. The advantage of such a saving vehicle becomes more pronounced as the time horizon of the investor increases. Given the above, it is not clear how advantageous someone with a relatively short saving horizon would actually find such a saving vehicle, but an investor with a longer saving horizon is likely to find it very attractive.

Now, instead assume an objective of increased saving for the purpose of retirement income in the future. The proposal does increase the incentive to save for retirement through an IRA-type of vehicle by allowing the individual access to money before retirement should it be needed for qualified purposes. In 1993, among the 53.6 million civilian workers not participating in any type of employment-based retirement plan, only 6.3 percent reported having contributed to an IRA in the previous year. Therefore, 94 percent of those eligible to utilize a tax-deferred IRA choose not to do so. It is often speculated that this is due to a lack of money on the part of lower income workers, but these results hold across different levels of income. Only 2 percent of those eligible for a tax deductible contribution in the lowest earning bracket (under $5,000 annually) contributed to an IRA. While the contribution rate among eligible higher earners is greater, the vast majority still do not participate. Seventy-six percent of those with earnings of $50,000 or more and not participating in an employment-based plan did not contribute to an IRA.

An additional reason hypothesized for low participation rates among those eligible is that individuals, especially lower income individuals, are reluctant to put their saving in a vehicle where it is beyond their reach (without significant tax penalty) should they need it before retirement age. The ADSA proposal would ease such concerns by allowing access to the money after five years for first time home purchase, education expenses, or medical expenses. This should result in increased IRA participation through ADSAs, but again the question is by how much? This is very hard to predict with precision. Again, the fact that individuals are only allowed to withdraw money without tax penalty under a limited number of circumstances, and then only after five years, may still discourage these types of individuals (current eligibles choosing not to participate) from participating in an ADSA.

Any worker is currently allowed to make an after-tax contribution of up to $2,000 to an IRA as now structured. Earnings accumulate tax deferred and income tax is not paid on them until distribution. While hard data on the use of IRAs on an after-tax basis are lacking, it seems that such behavior is relatively rare. The existence of ADSAs would create an increased incentive for such saving as the mechanics are essentially the same with the added bonus that the earnings are not taxed, even at distribution (and there is also the availability to withdraw the money before age 59 1/2 for qualified reasons).

Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA. Income tax would be paid on the rollover amount at the time of rollover, but future earnings would accrue tax free and any distribution would not be taxed if qualified as outlined above. (It is not clear how the rollover of IRAs consisting of after-tax contributions would be treated for tax purposes.) Such a rollover would be permitted no matter what the source of the IRA money, whether the result of regular tax-deductible contributions or of a rollover of a lump-sum distribution from an employment-based retirement plan such as a 401(k). This means that literally hundreds of billions of dollars in "retirement savings" would be eligible for rollover into ADSAs. Over the period 1977-1992, almost 119 million tax filers claimed a deduction for IRA contributions and the amount claimed for deduction was over $252 billion. Rollover contributions to IRAs are even more significant in terms of dollars. In the 4-year period of 1987-1990 alone, 11.2 million rollover contributions were made to IRAs, totaling $220 billion.

For some individuals, the tax gain from such a rollover would create a strong incentive to take advantage of the opportunity. Among those with such an incentive would be individuals who already planned to tap into the IRA in the future for one of the qualifying reasons, for example, a parent who planned to access some of their account in 10 years to finance a child's education. By rolling over into an ADSA, they would avoid the 10 percent penalty tax at the point they took money out for the education expenses.

IRA participants must commence benefit payments by April 1 of the calendar year following the calendar year in which they reach age 70 1/2. The penalty for failure to make a required distribution of (at least) the correct amount is a nondeductible excise tax of 50 percent of the difference between the minimum required amount and the actual distribution.[6] An individual who did not want the money till a later age would find it to his advantage to roll the money into an ADSA where it would grow tax free (after payment of income tax at the time of rollover) till the time of distribution. There would be no penalty for funds left in the account after age 70 1/2. This is better than taking a distribution at age 70 1/2, paying income tax on it, and then investing it on a non-tax sheltered basis till the money is needed.

There is currently an excise tax of 15 percent on any income from tax-preferred retirement plans combined in excess of $150,000 annually (indexed for inflation). Individuals expecting to be impacted by this excise tax would have the incentive to roll any IRA funds into an ADSA. They could then make withdrawals from the ADSA at their discretion so as to not incur the excise tax on this amount.

Beyond these three scenarios, the advantage of a rollover depends upon what one anticipates happening to their tax rate between now and retirement age. If one expects to be in a lower tax bracket in retirement, then one would be better off leaving the funds in the existing IRA. If, however, one anticipates tax rates increasing over time, then it would make sense to roll over into an ADSA.

None of the money rolled over would represent new additions to saving. It would all merely be a shift of existing saving from IRAs to ADSAs. These rollovers would generate tax revenue for the government at the time of rollover but would mean less tax revenue in the future. Such a shift would have potentially noteworthy implications for retirement income security. After five years, such money would be available tax free for the qualifying purposes. To the extent that such withdrawals occurred, it would be at the price of future retirement income. This represents a dramatic shift of policy objective away from saving for retirement income security to saving in general. Under the proposal, significant sums of money that had been accumulated in tax-preferred vehicles earmarked for retirement income would be made available for other purposes. It can be argued that some of the spending, such as a home purchase or additional education for the owner, would enhance retirement income security; however, the shift in emphasis from retirement saving to generic saving remains important because of the potentially dramatic implications for retirement income in the future.

Conclusion

The American Dream Savings Account proposal creates a new type of tax-preferred saving vehicle for individuals. As proposed, an ADSA is a less restrictive type of individual retirement account (IRA). The longer an individual's investment horizon, the more attractive will be saving through an ADSA. In addition, individuals eligible to make tax-deductible IRA contributions, but who have not done so in the past, may find the ADSA option attractive since it allows access without tax penalty to the savings before retirement if the money is used for a qualifying reason (first time home purchase, education expenses, and medical expenses). Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA, meaning that literally hundreds of billions of dollars in "retirement savings" would be eligible for rollover into ADSAs. This represents a dramatic shift of policy objective away from saving for retirement income security to saving in general, with potentially dramatic implications for retirement income in the future.

Endnotes

[1]Under current law individuals who are not active participants in a qualified employment-based retirement plan can make fully tax-deductible contributions up to a $2,000 maximum per year to an individual retirement account (IRA). Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose adjusted gross income (AGI) does not exceed $25,000 (single taxpayers) or $40,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI falls between $25,000 and $35,000 (single taxpayers) and between $40,000 and $50,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution of less than $2,000 and a nondeductible IRA contribution for the balance, as follows. The $2,000 maximum deductible deduction is reduced by $1 for each $5 of income between the AGI limits. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI is at least $35,000 (single taxpayers) or at least $50,000 (married taxpayers filing jointly) may only make nondeductible IRA contributions of up to $2,000; earnings on the nondeductible contribution are tax deferred until distributed to the IRA holder. IRAs can also be established as rollover vehicles for lump-sum distributions from employment-based pension plans or other IRAs.

[2]Distributions from an ADSA would also be tax exempt in the event of the death or disability of the account owner.

[3]Distributions from IRAs are taxed as ordinary income in the year received, except for the portion of the total IRA distribution that is attributable to nondeductible contributions, which are excludable from gross income. Taxable distributions prior to age 59 1/2 are subject to a 10 percent penalty tax, unless they are taken as part of a series of equal payments made for the life (or life expectancy) of such employee and his or her beneficiary, or the IRA owner dies or becomes disabled.

[4]It is not clear how the rollover of IRAs consisting of after tax contributions would be treated for tax purposes.

[5]H.R. 6 stipulates that for a distribution to be a "qualified special purpose distribution," it shall not include any payment or distribution to the extent such payment or distribution reduces the balance of the amounts in ADS accounts of the taxpayer below $1,000.

[6]The minimum amount that must be paid each year is determined by dividing the account balance by the applicable life expectancy. The applicable life expectancy is the life expectancy of the employee, or the joint life expectancies of the employee and the employee's designated beneficiary, if any. The life expectancy of the employee and/or the employee's spouse can be recalculated annually; however, the life expectancy of a beneficiary other than a spouse cannot be recalculated.

Chairman ARCHER [presiding]. Thank you very much, Mr. Yakoboski.

Mr. Mehos.

STATEMENT OF MANUEL J. MEHOS, CHAIRMAN, CHIEF EXECUTIVE OFFICER AND PRESIDENT, COASTAL BANC SAVINGS ASSOCIATION, HOUSTON, TEX., ON BEHALF OF SAVINGS & COMMUNITY BANKERS OF AMERICA, WASHINGTON, D.C.

Mr. MEHOS. Thank you, Mr. Chairman.

My name is Manuel J. Mehos; I am chairman of the Coastal Banc Savings Association of Houston, Tex. I am testifying today on behalf of a national trade association representing more than 2,200 community financial institutions whose members focus on providing real estate, finance and community financial services. Until yesterday, the name of my trade association was the Savings & Community Bankers of America. Yesterday, our board of directors voted to change the name of the association to America's Community Bankers to better reflect our emphasis on community banking.

Thank you for this opportunity to appear today in support of the American dream savings account and the need to expand the ability of Americans to save for their own retirement. We commend you, Mr. Chairman, and the other members of the committee for working to provide incentives for Americans to increase their savings.

In addition to encouraging retirement saving, the American dream savings account would also make it easier for Americans to save for their first homes, pay educational and medical expenses, and purchase long-term care insurance. The members of America's Community Bankers are focused on home mortgage lending, and we strongly support all efforts to make housing more affordable. But we believe that more needs to be done to encourage retirement savings.

America's low level of saving contributes to a chronic budget deficit that requires foreign capital to finance. The low level of retirement saving by the baby boom generation has put them on a collision course with their own retirement needs. The retirement needs of the baby boomers will be even greater than those of the current generation of retirees, because their life expectancies may be greater and because their Social Security benefits will very likely have to be reduced.

It now appears that the Social Security Trust Fund will have insufficient funds when the baby boom generation retires to maintain the current level of benefits without increasing taxes. We believe that one of the best vehicles ever created to increase individual retirement saving is the deductible IRA. We disagree with those who say that participants in deductible IRAs just shift assets from taxable accounts to their IRAs. There is a wealth of significant analysis proving that IRAs significantly increased saving during the early eighties, when their availability was expanded.

We respectfully request that the committee consider expanding the American dream savings account to include a deductible IRA feature that would be available to all workers and their spouses. We strongly support the Savings and Investment Incentive Act of

1995, just introduced by Congressmen Thomas and Neal of the committee, and the corresponding Senate bill introduced by Senators Roth and Breaux. The Savings and Investment Incentive Act of 1995 includes a deductible IRA and additional features very similar to the American dream savings account.

This morning, I listened to my esteemed Senator from Texas, Kay Bailey Hutchison, whom I strongly support. I believe homemakers' daily duties and responsibilities are infinitely more difficult than my own—that is a personal opinion—and they certainly should be treated the same as a wage earner. Therefore, I am confident that I speak for my colleagues when I say that we support Senators Bailey Hutchison's and Mikulski's bill, which allows equal IRA contributions for homemakers.

We understand that enactment of a deductible IRA may require the Congress to come up with offsetting revenue in the form of tax increases and spending cuts—or spending cuts. The Congress is committed to cutting government spending already, and it would make sense to, in effect, use some of that saving to enact an expanded IRA.

Reliable studies have shown that for every dollar of tax revenue given up in the form of an IRA deduction, a much larger amount of new savings is created. We think that the tradeoff is worth it for the long-term good of this country. IRAs are good for America and we hope that their availability and flexibility will be expanded.

Thank you, Mr. Chairman, for permitting me to appear here today. I very much appreciate your efforts to increase savings and will be happy to answer any questions at the conclusion of the panel.

[The prepared statement follows:]

TESTIMONY OF MANUEL J. MEHOS
SAVINGS & COMMUNITY BANKERS OF AMERICA

Mr. Chairman and members of the Committee, thank you for this opportunity to appear today. My name is Manuel J. Mehos, and I am the Chairman, President, and Chief Executive Officer of the Coastal Banc Savings Association in Houston, Texas. I am here today testify on behalf of Savings & Community Bankers of America (SCBA), of which Coastal Banc Savings is a member. SCBA is a national trade association representing an industry of more than 2,200 savings and community financial institutions with more than 16,000 offices, 285,000 employees and nearly $1 trillion in assets. Its members focus on providing real estate finance and community financial services.

Mr. Chairman, SCBA commends you and other Members of Congress for advancing a proposal that would encourage saving by Americans – The "American Dream Savings Account." The American Dream Savings Account would, if enacted, help and encourage Americans to save for those events that, next to retirement, are the most expensive they will face -- the purchase of a first home, a family's higher education expenses, and medical expenses, including purchases of long-term care insurance.

The ADSA could be set up in addition to an Individual Retirement Account and, although contributions could only be made with after-tax dollars ("back-loaded"), the earnings on the account would be tax-free. The annual contribution limit would be the lesser of $2,000 or the participant's annual compensation. Unlike a regular IRA, the compensation of married couples could be aggregated to permit a $4,000 contribution by the couple, even though only one partner worked, and the annual contribution limit would be adjusted annually for inflation. The IRA rule that requires contributions to cease and distributions to commence at age 59 1/2 would not apply and contributions could be made after 70 1/2. No penalty would apply to ADSA amounts withdrawn after five years for any of the three nonretirement expenses mentioned previously. Individuals would have a one-time opportunity to convert their IRAs to ADSAs and spread the income tax due on the amount transferred over four years.

The savings institutions industry, the primary function of which is lending to homebuyers, strongly supports the creation of a savings vehicle that will bring home ownership within reach for more Americans. Using IRA funds for this purpose merely converts one type of long-term investment into another.

The other goals of the ADSA are likewise worthwhile. Only by making higher education affordable for more Americans can we compete successfully in a global economy. Permitting Americans to use their savings without being subject to a tax penalty in the event of serious illness is also sensible.

The greatest threat to our future competitiveness and prosperity is our low rate of accumulation of financial assets for long-term retirement savings. The dramatic decline in discretionary private savings has been widely reported and analyzed.[1] The American people are not saving adequately, in general, and, in particular, their

[1] The U.S. "personal savings rate" dropped from 5.6% during 1981-5 (the period of expanded IRA availability) to 3.4% during 1986-94 (Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, December 1994). According to the Congressional Budget Office, the "national savings rate" dropped from 3% during the period 1981-93 to 1.7% in 1993 (statement of Senator William Roth, Congressional Record, January 4, 1995).

retirement savings relative to their retirement needs are woefully inadequate.[2] Contractual savings in the form of employer-sponsored plans, which have long been a growing and dominant feature of our total savings, cannot be expected to fill all our future needs. The insufficiency of individual retirement saving is being accompanied by the steady elimination or radical restructuring of traditional, private sector employer pension plans. Moreover, when the "baby-boom generation" retires, its members cannot count on as generous a level of inflation-adjusted Social Security payments as received by current retirees. At that time, the then-current work force may very likely be unable and/or unwilling to pay taxes at the level required to make good on the vast unfunded liabilities bequeathed to them in the form of Social Security, Medicare, and federal pension benefits owed to the baby boomers.

The savings goals of the ADSA are commendable, but more needs to be done. The critical lack of retirement savings in this country must also be considered when evaluating the merits of tax-advantaged savings plans for individuals. It is the view of SCBA that the tax-deductible Individual Retirement Account is one of the most effective means ever devised of encouraging individual retirement saving. IRAs were created in 1974 for workers who were not participants in employer-sponsored retirement plans. The Economic Recovery Tax Act of 1981 made it possible for any wage earner to establish an IRA and increased the limit on deductible annual contributions from $1,500 to $2,000 ($4,000 where both spouses worked and $2,250 where only one did).

The Tax Reform Act of 1986 limited the deductibility of the $2,000 contributions where the individual or spouse is a participant in an employer's plan. The deduction is phased out for such individuals who have adjusted gross income from $25,000 up to $35,000 (between $40,000 and $50,000 for married individuals). Amounts withdrawn from an IRA before age 59 1/2 are subject to a 10 percent premature distribution penalty, unless the distribution is due to death, disability, or in the form of an annuity.

SCBA maintains that when the Tax Reform Act of 1986 reduced availability of IRAs, a very important incentive for retirement saving was eliminated, one that had a significant impact on long-term capital formation. It is our position that enactment of S.12, the "Super IRA," more commonly referred to as the "Roth-Breaux IRA," would be the best possible way to increase long-term retirement saving, while providing considerable flexibility to participants.

The Roth-Breaux IRA combines both the traditional IRA and a short-term savings vehicle called an "IRA Plus" Account, which accepts after-tax contributions and permits them and their earnings to be withdrawn penalty-and-tax-free after five years. Both the regular IRA feature and the IRA Plus Account permit withdrawals: to buy a home; pay education expenses; pay catastrophic health care costs; or to meet expenses during a period of long-term unemployment. Conversions from IRAs to IRA Plus Accounts will be permitted without penalty and, if the conversion is made before 1997, the income tax owed may be spread over four years.

SCBA strongly recommends that the Congress enact the Roth-Breaux Super IRA as the best possible means to increase the nation's long-term savings. There is no question that from 1981 through 1986 -- the period of existence of the universal IRA -- the savings rate of this country significantly increased. It is the strongly-held belief

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[2] See, e.g., Is The Baby Boom Generation Preparing Adequately For Retirement? Report prepared by B. Douglas Bernheim, Ph.D., (Princeton University), January 15, 1993, Sponsored by Merrill Lynch & Co., Inc.

of our members, based on their own experiences, that the expansion of the availability of IRAs caused this increase in saving.

Nevertheless, an argument often made is that the availability of deductible IRAs results principally in a shift of existing savings from the taxable accounts of the participant. Chairman Alan Greenspan, in his testimony before the Finance Committee on the predecessor of the Roth-Breaux Super IRA -- the Roth-Bentsen Super IRA, S.612 -- noted that the many analysts believed that during the 1982-86 IRA experience "little, if any, of the money flowing into the accounts represented new saving -- a perception that undoubtedly contributed to the scaling back of IRAs as part of tax reform in 1986." He continued, however,

> Since then, many new data have become available, and several studies of the IRA experience have been carried out. These studies provide a wealth of information, but again, the results are inconclusive. Some essentially confirm the "conventional wisdom" that IRAs involved primarily a shifting of saving from one pile to another, without much effect on the total. But others suggest that IRAs provided a substantial boost to overall saving and that their effectiveness would have grown over time as people exhausted their opportunities to shuffle existing assets.[3]

We find the latter group of studies far more compelling based on their consistency with the experience of our member financial institutions. The individual authors reached their conclusions -- that IRAs do stimulate new saving -- by means of a variety of analytical techniques, not the least important of which appears to be common sense.[4]

It is uncertain based on our experience with the currently available back-loaded IRA whether the ADSA will be as effective at stimulating saving as a tax deductible IRA. Those of our customers who have lost eligibility to make deductible IRAs have, in general, shown relatively little interest in making the after-tax IRA contributions, despite the opportunity to defer tax on the earnings of the account. Professor Steven F. Venti, in his testimony before the Senate Finance Committee on December 7, 1994, speculated that a combination of tax deduction psychology and institutional promotion may have helped to make deductible IRAs so popular when they were available to all workers.

Obviously, there has been a significant reduction in IRA advertising since 1987. The sense of our members, however, is that ability to actually see a reduction in tax liability on their tax returns created an even more powerful psychological impetus in favor of IRA participation among our customers. The fact that the ADSA cannot tap into this psychology will make it less attractive than a regular IRA, although the fact that an ADSA's funds are not "locked-up" by the IRA premature distribution rules will to some extent create a countervailing psychological effect. The ADSA, quite obviously in our view, will not be as effective as the Roth-Breaux Super IRA in

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[3] Testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Finance, U.S. Senate, May 16, 1991.

[4] See, e.g., Testimony of Steven F. Venti, Professor of Economics, Dartmouth College, to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994; Testimony of Richard H. Thaler, Professor of Economics, Cornell University, to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994; Stephen F. Venti and David A. Wise, The Evidence on IRAs, Tax Notes, January 25, 1988, at p. 411; Martin Feldstein, The Effects of Tax-Based Savings Incentives on Government Revenue and National Saving, National Bureau of Economic Research, Working Paper No. 4021, March 1992.

stimulating long-term saving.

The Super IRA, however, may well be "scored," as costing considerably more in anticipated lost revenue than the ADSA under the current Congressional budget procedures. Thus, the Super IRA may be politically less feasible. Nevertheless, the impact of a budgetary evaluation that occasionally appears artificial should not prevent us from considering other views of the economic impact of deductible IRAs. Quite simply, because the increase in personal savings significantly exceeds the resulting decline in tax revenues, in our view, the Super IRA is worth doing. Professors Steven F. Venti of Dartmouth College and David A. Wise of Harvard University, for example, have concluded that each marginal dollar of deductible IRA contribution is financed by a more than 50 cent reduction in consumption, a 20 to 30 cent reduction in taxes, and a reduction of other savings of 20 cents or less.[5]

We completely concur with the views of Harvard Professor Lawrence H. Summers, now on leave as U.S. Treasury Undersecretary for International Affairs:

> The weight of the available evidence suggests that IRAs generated a significant amount of saving that would otherwise not have taken place. If [deductible] IRAs were reinstated under current law, the government would lose about twenty-five cents for each one dollar of contribution. If more than one-fourth of the money contributed to IRAs represents new saving, IRAs will increase private saving by more than their revenue cost. If this condition is met, the case for reinstating IRAs is clear. Even if it is not, there is still a strong case for saving incentives given that the restoration of IRAs would be likely to come at the expense of other tax breaks rather than at the expense of larger deficits.[6]

The last sentence of Undersecretary Summer's statement makes a point that is applicable in the context of an analysis limited by Congressional budgetary procedures. Assuming the data does show that the increase in invested capital created by deductible IRA contributions would be significantly greater than the resulting decrease in tax revenue, this would be, in our view, a compelling reason for reinstating deductible IRAs. In any case, the constraint imposed by Congressional budgetary procedures would compound the benefit of enacting deductible IRA legislation. If deductible IRA legislation were enacted with the loss of tax revenue being offset by corresponding cuts in federal spending, a very powerful means of increasing the supply of domestic funds available for investment would be created.

At the very least, we would advocate the untrammelled availability of deductible IRA contributions for those employees who are participants in a defined benefit plan but who have not yet reached the vesting threshold for those benefits. Under current rules, it is possible for a worker, who is continuously employed and a participant in defined-benefit pension plans at every employer, to never qualify for a dollar's worth of defined benefits if he or she switches jobs every three years. The availability of an unrestricted IRA would so something to fill that gap.

In summary, we are very appreciative of the opportunity for increasing saving, both for retirement and certain worthwhile expenditures, represented by the proposed

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[5] See Stephen F. Venti and David A. Wise, The Evidence on IRAs, Tax Notes, January 25, 1988, at p. 415.

[6] Lawrence H. Summers, Stimulating Personal Savings in The U.S. Savings Challenge: Policy Options for Productivity and Growth, Edited by Charles E. Walker, Mark A. Bloomfield, and Margo Thorning (Boulder, Colorado: Westview Press, 1990), at p. 170.

American Dream Savings Account and we strongly urge the Congress to pass this important part of the Contract With America. As we have said, however, more needs to be done to address the critical lack of retirement saving and investment in America. That is why we urge the Committee to consider adopting, as an expansion of the concept of the American Dream Savings Account, the additional provisions of S. 12, the Roth-Breaux Super IRA. I would be pleased to answer any questions.

Thank you.

Mr. THOMAS [presiding]. Thank you, Mr. Mehos.

The Chair would note, a former member of the committee, the Governor of Tennessee, who is with us.

Mr. Sawyer, you may continue.

STATEMENT OF JAMES E. "TOM" SAWYER, CHAIRMAN OF THE BOARD, AMERICAN ASSOCIATION OF ENGINEERING SOCIETIES, WASHINGTON, D.C.; AND SENIOR VICE PRESIDENT, GREINER, INC., TAMPA, FLA.

Mr. SAWYER. Mr. Chairman, my name is Tom Sawyer. I am from Tampa, Fla., where I have practiced civil engineering for 40 years. I am here to represent the Engineers' Public Policy Council of the American Association of Engineering Societies. Our organization represents 800,000 professional engineers and 28 engineering societies, and our policy regarding pensions has been developed by the Engineers and Scientists Joint Committee on Pensions, which has 32 societies as its membership.

We are concerned about our members and about those that practice our profession, and that is the reason I am here to testify. We are concerned that we want them to be able to continue to contribute to the quality of life of my grandchildren and yours and, sometime, wind up with an economically secure future upon retirement.

Many engineers started work in their profession with a concept of lifelong employment. I have worked for one firm for 39 years; that will never happen again. Engineers are globally competitive; we have to go where the technology is needed and where it is required. There are frequent job changes.

There is considerable spotty unemployment in the various professions of engineering, particularly when the focus changes from space to infrastructure and so forth, and it is increasingly difficult for engineers to save for their future. And yet we are all contributing to the technology that makes the information highway possible, improves the quality of life.

I am testifying on behalf of the proposed American dream savings account for several reasons. First of all, it would permit individuals to make a $2,000 contribution, after they have paid taxes. But second, it would recognize that my wife, who is a homemaker, elected that as a career, is equal in importance to me and gets her $2,000 advantage.

We think that it is a good idea for the amounts in the ADSA to be available for retirement, or for a first-home purchase, or for postsecondary educational and medical expenses, but we hope that you will include provisions that will regard this preretirement expenditure as a loan that could be repaid and preserve the advantages.

There is an important feature of the ADSA that has some level of excitement, and that is, it does not permit the government to benefit from the devaluation of currency. Many of us have saved all of our lives and have a lot more dollars now, but the dollars we put in were quite valuable and hard to come by and the ones we are getting back don't buy very much. I think this is a poor concept, and I hope you will consider it as you deliberate amongst the options.

It is important for government to adopt policies that encourage individual responsibility, that encourage me to save for my future, my retirement. My mother saved very hard-earned dollars, and the government took them away from her because, when she got ready to go into a retirement home, the cost was an incredible amount to her. I think the ADSA would not cost the government over the life cycle of the government, because I think you would have fewer people in nursing homes on welfare and at government expense. My mother paid her last nursing home bill with her last dollar, but most of the people in the nursing home were there at my expense as a taxpayer.

So I don't think you need to look at this as revenue-neutral, because I think you will get the money back. Let's face it. When I leave this Earth, the government is going to get a whole lot more of my money than my grandchildren will anyway. You will get it one way or another.

We do strongly support the flexibility of savings and savings options. We certainly hope that as you consider the ADSA that you won't modify the provisions of the 401(k)s, the IRAs, or other retirement plans. We are committed to you in enhancing the portability of retirement plans, and we encourage you to consider that the middle class deserves the incentive and the commitment to valued savings that this bill would provide.

That concludes my testimony, and I would be glad to answer any questions.

[The prepared statement and attachment follow:]

STATEMENT OF JAMES E. SAWYER
AMERICAN ASSOCIATION OF ENGINEERING SOCIETIES

Good afternoon, Mr. Chairman and Members of the Committee.

On behalf of the Engineers' Public Policy Council of the American Association of Engineering Societies (AAES), I am pleased to have this opportunity to testify before you today on the American Dream Savings Account. My name is James E. Sawyer, and I am the Chairman of the Board of AAES. I am a senior vice president of Greiner, Inc., in Tampa, Florida. AAES is a multidisciplinary organization dedicated to coordinating the collective efforts of over 800,000 members represented by 28 engineering and scientific societies to advance the knowledge, understanding and practice of engineering. (A list of AAES member societies is attached to our statement). AAES activities on retirement income issues are coordinated by the Engineers and Scientists Joint Committee on Pensions (ESJCP). ESJCP consists of 32 engineering and scientific professional societies. In the past, ESJCP has been active on issues such as pension portability and Individual Retirement Accounts (IRAs).

Background

AAES is committed to improving opportunities for engineers and other workers to earn retirement income that will enable them to remain economically secure at the conclusion of their working lives. As the 21st century approaches, demographic and economic changes are imposing severe strains on the nation's retirement income delivery system. For most workers, including engineers, career-long employment with one company is a thing of the past. The engineering community is on the cutting edge of advancements which are rapidly altering the global workplace. Engineers are already experiencing periodic unemployment, frequent job changes, and increasing reliance on part-time, temporary, or contract employment. These changes not only affect workers' current livelihood, but their future retirement income security as well. We are also concerned that declining rates of personal savings, including retirement savings, are having adverse affects on the availability of capital for productive investment in the national economy.

AAES believes that access to retirement income plans is a fundamental economic problem that will reach crisis proportions within the next two to three decades if it is not addressed soon. In the twenty years since enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the American economy has embarked on a period of extraordinary change. Technology, which produces untold benefits for society, is evolving at such a rapid pace that it has indirectly contributed to widespread corporate restructuring and downsizing at a time when other countries increasingly compete with the U.S. in the global marketplace.

The end of the Cold War has brought massive defense downsizing.

In today's unsettled environment, U.S. employers are transferring greater responsibility for retirement planning and saving to employees -- but most workers are not preparing adequately for the future. Fewer than half of all workers have access to or are covered by employer-provided pension plans, and worker mobility reduces the value of these benefits for many of them. Few workers are saving enough on their own to ensure secure retirement, and changing demographics threaten the Social Security system.

Over the next few decades, record numbers of people will be retiring as the post World War II generation reaches retirement age. A coherent national retirement income policy is needed to respond to this reality.

American Dream Savings Account

The proposed American Dream Savings (ADS) account could serve as a pillar of a national retirement income policy. Section 4 of H.R. 6, the American Dream Restoration Act would:

* Permit individuals to make taxed contributions of up to $2,000 a year ($4,000 for couples) to new ADS accounts, irrespective of personal income or pension status. Contribution limits would be indexed for inflation beginning in 1997.

* Provide that amounts held in ADS accounts for at least 5 years could be withdrawn (tax and penalty free) to pay for retirement, a first home purchase, post secondary educational expenses and medical expenses, including long-term care.

* Provide that within 2 years of the enactment of the ADS, current IRA participants could cash out their current IRA and pay the tax due (tax liability could be spread over 4 years) on it without having to pay any penalty, provided the money is transferred to an ADS. The rollover could be made without regard to the $2000/$4000 limitation.

It is important for federal, state, and local governments to work toward an environment which would enhance and encourage individual retirement income planning and savings. Individuals have a responsibility to save for their own retirement, and the ADS account would be a positive step in encouraging this action. The ADS account would provide an additional incentive to begin a personal savings account to provide for retirement income for workers who are not able to accumulate retirement benefits. The ADS account is, therefore, an effective expansion of current retirement income choices, and we commend the legislators who developed this proposal.

We strongly recommend, however, that this account should not in any way supersede or replace any existing retirement savings options such as 401(k)s or IRAs. It should act as a supplement to other available means of savings for retirement and as an enhancement to an individual's options for retirement income.

Additionally, while we recognize the options available within the ADS account for purposes such as saving for a first-time home purchase and the payment of higher education costs, we feel it is important to note that if an individual elects to use this account for retirement savings, withdrawals for other purposes should be made cautiously, and the individual should be encouraged to repay his or her own account. This could be accomplished through loans that one would repay to one's own account as is currently allowable under 401(k)s, in order to preserve retirement savings.

Other Elements of a National Retirement Income Policy

The establishment of ADS accounts would be a welcome addition to national retirement income policy. Other changes are necessary, however. AAES recently issued a statement on national retirement income policy to help alert the nation to the dimensions and magnitude of the impending crisis and to contribute to the development of effective solutions. In that statement, AAES calls upon business and industry; federal, state, and local governments; educational and financial institutions; labor organizations; professional and technical societies; and, other voluntary associations and concerned citizens to:

- Promote enactment of legislation to enhance and encourage retirement income planning and saving;
- Create a coherent national retirement income policy to facilitate thorough analysis and effective resolution of related problems; and
- Educate the public about retirement income needs and responsibilities.

Legislative Action

Recognizing the critical role of the federal government as a catalyst for change and a focal point for public debate about retirement income policy issues and the development of legislation needed to strengthen the nation's retirement income delivery system and increase savings needed for productive investments in the national economy, AAES calls upon the President and Congress to:

- **Improve employer-sponsored pension plans** by encouraging employers in the private and public sectors to sponsor and adequately fund pension plans for employees; reduce vesting requirements; guarantee portability of vested benefits when workers change jobs; and promote preservation of pension distributions for use in retirement.
- **Increase individual savings for retirement** by encouraging more employers to provide employees with voluntary retirement savings plans and by increasing opportunities for individuals to contribute to tax-favored retirement savings arrangements, including Individual Retirement Accounts (IRAs), and Keogh plans for the self-employed. As an objective, rules governing IRAs should be modified to: (1) encourage more individuals to participate; and (2) increase the IRA deduction limit and adjust it annually for inflation. **The proposed ADS account would be an effective servant of this objective.**
- **Strengthen the Social Security system** to ensure its continuing solvency and reliability as a source of income for retired workers and their families, for the survivors of deceased workers, and for disabled workers and their families.

National Retirement Income Policy

AAES urges the federal government to make a commitment to the retirement income security of the American people by developing a comprehensive national retirement income policy. The purpose of the policy would be to give high-level focus to this crucial issue. AAES envisions that such a policy would encompass both thorough analysis of these problems and a vigorous, fiscally responsible effort to resolve them.

AAES does not recommend a new government-funded entitlement program. It sees government's role as that of a facilitator -- developing consensus, cooperation, and appropriate incentives that will encourage employers to provide retirement savings opportunities and encourage individuals to save adequately for retirement.

Sustained commitment and leadership are essential if the nation is to meet this challenge. One way of achieving the desired result is to establish a federal commission on retirement income policy to analyze trends in savings, propose incentives to increase savings, assess alternative financing arrangements, evaluate the feasibility of occupational retirement plans, and recommend actions to achieve the needed reforms.

Public Education

We all must act now to assure the future ability of America's workers to remain economically secure in their retirement years. Government cannot do it alone. Meeting this challenge will also require the support of individual workers, their employers, and the voluntary organizations to which they belong.

All individuals must be encouraged to plan and save for retirement. To this end, AAES and its member societies will educate engineers and others about the need to save for retirement and encourage them to make needed financial preparations throughout their working lives.

Employers should be encouraged to provide retirement income savings opportunities for their employees. These options should be flexible and responsive to the changing needs and requirements of increasingly mobile workers. To this end, AAES encourages employers to adopt human resource strategies that will enhance the retirement income security of their workers.

The issue of retirement income policy has crucial long-term ramifications for all Americans. AAES recognizes the importance of cooperative action to avert an impending retirement income crisis. It accords this issue a high priority, and will work to mobilize members in support of appropriate legislative and regulatory actions, and to involve concerned citizens in cooperative efforts to develop a coherent national retirement income policy and strengthen the nation's retirement income delivery system.

In closing, we applaud the commitment of both the President and Congressional leaders to help more individuals and families save for retirement by strengthening incentives to invest. Under the broad-based IRAs contained in H.R.6 and the President's Middle Class Bill of Rights, certain tax advantages would accrue to those Americans who avail themselves of the savings opportunities these proposals provide.

Thank you for the opportunity to present our views to you.

1995

AAES Member Societies

American Academy of Environmental Engineers
American Indian Science & Engineering Society
American Institute of Chemical Engineers
American Institute of Mining, Metallurgical and Petroleum Engineers
American Institute of Plant Engineers
American Nuclear Society
American Society for Engineering Education
American Society of Agricultural Engineers
American Society of Civil Engineers
American Society of Mechanical Engineers
Institute of Electrical & Electronics Engineers
National Institute of Ceramic Engineers
National Society of Professional Engineers
Optical Society of America
Society of Fire Protection Engineers
Society of Hispanic Professional Engineers
Society of Women Engineers

Advisor/Observer

National Academy of Engineering

AAES Associate Societies

Association for International Practical Training
Federation of Materials Societies
INFORMS
National Action Council for Minorities in Engineering
NACE International
National Council of Examiners for Engineering and Surveying
Tau Beta Pi Association
The American Society for Nondestructive Testing, Inc.

AAES Regional Societies

District of Columbia Council of Engineering & Architectural Societies
Engineering Society of Detroit
Washington Society of Engineers

Mr. THOMAS. Thank you very much, Mr. Sawyer.

Does any member of the majority wish to inquire? Any member of the minority?

Mr. JACOBS. Thank you.

Mr. THOMAS. Let me just say briefly that one of the most frustrating things about trying to analyze the IRA in any kind of a real-world situation—I believe, Mr. Mehos, you touched on it—is that frankly it was in effect for so short a time that the effect in the business of trying to educate people about an instrument available to them and then having it taken away, does not give me a comfort level on anyone extrapolating from the time period when we saw it in effect to what could have happened to it and who may have made use of it.

Mr. Yakoboski, you indicated that 90 percent of those eligible don't do so. Do you have any evidence, even anecdotal, about the shortness of the time period, or the fact that people feel that they are a little more gun shy than they would be because of these stop-start offerings that government has made in terms of these kinds of proposals—any reaction at all?

Mr. YAKOBOSKI. I think it is fair to say that when the rules of the game are changed on a fairly regular basis that naturally the average person is confused; and as was raised earlier, maybe one of the reasons for low participation rates among those eligible, to make a tax-deferred contribution is potentially that they are not—they don't know necessarily that they are eligible.

On the other hand, the numbers I cited were those who do not have an employment-based plan and thus for whom an IRA was designed to provide a retirement plan and they are still not taking advantage of it. That ranges across the income spectrum, even among higher income individuals.

Mr. THOMAS. But are they aware that they could take advantage of the plan? Do you have any indication of how many of those who don't—10 percent do, 90 percent don't, but what is the information and the knowledge level among the 90 percent about the opportunity to do so?

Mr. YAKOBOSKI. I really don't have any feel for that.

Mr. THOMAS. That is part of my problem.

Mr. YAKOBOSKI. It is fair to say that in the heyday of IRAs, they were very widely pushed and marketed by the financial institutions.

Mr. THOMAS. The heyday was kind of like a rocket, wasn't it? It went up and came down.

Mr. Mehos.

Mr. MEHOS. I can comment on that a little bit. My bank has branches in many rural areas, as well as metropolitan Houston, and we found that in the rural areas they are much more popular and much more a part of their every-year financial planning, the IRAs. And a lot of that is because the rural communities tend to be an older community and they learned to invest in the early eighties when that window was there. They became creatures of habit in investing in an IRA.

The younger people today, even the ones that qualify in the metropolitan areas, I don't believe are really aware of it. They are aware of it, but they haven't become creatures of habit yet. So we found that it is infinitely more interesting in the older communities and in the rural communities where the older people are.

Mr. THOMAS. Well, we are going to keep looking for solutions to the savings rate problem, but I think most members believe there is no silver bullet. We also don't want to continue programs that aren't producing a response for the cost of the program. Between those two points, it is frustrating, because you can't just have new plans be additive if the old plans aren't worth their salt in what you hope to produce. We will continue to look at models. We have one in front of us that we believe has promise, and we appreciate your testimony, indicating that you think it does as well.

Thank you very much.

Now I would ask the last panel to come forward—Martin Jaffe, Joel Snyder, and W. Thomas Kelly. Please come forward.

First of all, I want to thank the panel for its patience, and thank you, second, for your willingness to testify before us today. I will tell all of you that, without objection, your written testimony will be made a part of the record and that you have 5 minutes to proceed as you see fit to inform the Ways and Means Committee. And again, I would start on my right and move to my left, Mr. Jaffe, you have 5 minutes.

STATEMENT OF MARTIN JAFFE, CFP, CHIEF OPERATING OFFICER AND MANAGING DIRECTOR, WOOD, STRUTHERS & WINTHROP; AND PRESIDENT, INTERNATIONAL ASSOCIATION FOR FINANCIAL PLANNING, ATLANTA, GA.

Mr. JAFFE. Thank you, Mr. Chairman and members of the committee. I am Martin Jaffe, and I am the president of the International Association for Financial Planning. I am also chief operating officer and managing director of the investment advisory and planning firm of Wood, Struthers & Winthrop, a subsidiary of Donaldson, Lufkin & Jenrette.

The IAFP is the oldest and largest financial planning organization. Our over 12,000 individual and institutional members are dedicated to the concept that objective advice developed through the financial planning process is the foundation for smart, effective decisionmaking.

The financial planning process begins with a clear understanding of the client's goals and culminates with a plan of action to achieve those goals. Our members use this process to help over 1.3 million families achieve their financial goals.

The IAFP believes that public policy should enhance opportunities for Americans to achieve their financial goals through their own initiative and prudence; and tax and economic policies should promote savings, investment, capital formation and a vigorous free enterprise system.

In an IAFP commissioned nationwide survey recently conducted by the Wirthlin Group, nearly 60 percent of adults said they were concerned that they were not saving enough for their retirement. This is up sharply from 43 percent who experienced a similar concern just a few years earlier. And over 80 percent of adults want to retire before the traditional age of 65. This demonstrates our concern that many Americans have not taken the necessary steps to achieve their worthy financial goals.

We find that our clients are more knowledgeable and financially sophisticated than ever before, and they want to provide for their own well-being. Real incentives such as tax-deductible IRAs and the American dream savings account will work.

Also, an increasing number of adult Americans today are in a "triple-squeeze" situation where they are trying to put away money for their children's college, support their elderly parents, while at the same time trying to save for their own retirement. These Americans need additional incentives for these important needs. Also, they must know that any savings incentives will be left intact and not changed every few years. It must be simple and predictable.

This reminds me of the recently passed tax legislation that excludes the interest earned on Series EE savings bonds when the proceeds are used to pay tuition for the taxpayer or his or her children. This exclusion is eliminated in stages when adjusted gross income exceeds $60,000 and completely eliminated when it exceeds $90,000. The problem and the provision that renders this exclusion impotent as an incentive is that an individual has to decide now, at the decision point of buying the EE bonds, what his income level will be 10, 15 and 20 years from now. We just think that Congress needs to keep those kinds of things out of legislation and let people understand what they are doing and the implications of it.

During the last 10 years, the national savings rate has been cut in half. We believe that extended IRAs and the American dream savings account will encourage Americans to save more.

My over 30 years' experience as a financial planner indicates that for a number of wealthy Americans, contributions to IRAs and ADSAs will serve as a substitute for other investments; however, it is also my experience that a far greater number of middle-income Americans will utilize tax-advantaged IRAs and ADS accounts to make new investments of funds that might otherwise be consumed.

Expanded IRAs and the ADS account will help middle-income Americans become homeowners, send their children to college, support themselves in retirement, as well as be a buffer for unexpected health care costs.

For these reasons, we support legislation to create more attractive personal savings vehicles. Expanded tax-advantaged savings options, such as those contained in the American Dream Restoration Act, will greatly encourage our citizens to plan and to provide for their own financial future. We are particularly encouraged by the potential of the ADS account to provide citizens with a significantly better means of obtaining their intermediate as well as their long-term financial goals. In other words, we see a need for the ADS account for intermediate needs and the tax-deductible IRA for retirement needs.

We also support the capital gains reforms proposed in title I, the Job Creation and Wage Enhancement Act, in the Contract With America. We believe that the 50-percent exclusion for long-term gains and inflation of assets will free up many assets currently frozen by the pending capital gains tax where investors who were successful with their prior investments would rather avoid a tax on these mature investments by waiting until their death.

In conclusion, we need to encourage increased savings and promote capital formation and investment in the United States. Enhanced IRAs, the American dream savings account and reduced capital gains tax will contribute significantly toward these goals. We urge Congress to adopt legislation this year encouraging these savings and investment goals.

Thank you.

[The prepared statement and attachments follow:]

Testimony of

Martin Jaffe, CFP
President
International Association for Financial Planning (IAFP)

before the
House Committee on Ways and Means
regarding
Savings and Investment

Tuesday, January 31, 1995
Washington, D.C.

Mr. Chairman and members of the Committee, my name is Martin Jaffe, and I serve as the volunteer President of the International Association for Financial Planning (IAFP). I am also Chief Operating Officer and Managing Director of the investment advisory firm of Wood, Struthers & Winthrop, a division of Donaldson, Lufkin & Jenrette. Thank you for the opportunity to testify on savings and investment issues.

IAFP is the oldest and largest financial planning organization in the nation. We are dedicated to the idea that objective advice supports smart financial decisions. IAFP represents more than 12,000 individuals and institutions that believe the financial planning process is the foundation for effective decision-making. The financial planning process begins with a clear understanding of the client's goals and ends with a plan of action to achieve those goals. Our members use this process to help over 1.3 million clients achieve a variety of financial goals, which normally includes long-term savings plans.

As a new member of the Executive Committee of the Savings Coalition of America, IAFP has reiterated our commitment to supporting incentives to increase personal savings in the United States. IAFP believes that:

- public policy should enhance opportunities for Americans to meet their financial needs through their own initiative and prudence; and
- tax and economic policy should promote savings, investment, capital formation and a vigorous free enterprise system.

INDIVIDUAL RETIREMENT ACCOUNTS AND THE AMERICAN DREAM SAVINGS ACCOUNT

The need for Americans to significantly increase their savings was demonstrated dramatically late last year when IAFP commissioned The Wirthlin Group to conduct a nationwide consumer survey. Survey results indicated that:

- nearly 60 percent of adults are concerned that they have not provided sufficiently for their retirement (up sharply from the 43 percent who expressed a similar concern just five years earlier); and
- over 80 percent of adults want to retire before the traditional retirement age of 65.

These results indicate that many people have worthy financial goals but frequently have not taken the necessary steps to achieve them.

A secure retirement may be the ultimate long-range financial planning goal for most of us. But many other important financial needs surface throughout our lives. As financial planners, we believe that it is important that American taxpayers be empowered to take control of their long-term financial futures.

We find our clients to be more knowledgeable and more sophisticated than ever before. However, the current system does not provide adequate incentives for them to save and invest. Real incentives, such as tax deductible Individual Retirement Accounts (IRAs) and the American Dream Savings Account (ADS), will work.

In another survey commissioned by the IAFP several years ago, we found that many American families were faced with the dilemma of saving for their retirement, putting money away for their children's college education, and insuring adequate resources to care for their elderly parents. This "triple squeeze generation" needs additional incentives to save for these important needs. Furthermore, to provide greater certainty in planning to meet these financial goals, Americans need to know that savings incentives in the tax law will be left intact and not changed every few years.

In the last 15 years the average net national savings rate has been cut in half from 4.7 percent during the 1980s to 2.4 percent during the 1990s. Personal savings rates also declined significantly during the past 15 years from an average of 7.8 percent of personal income during the 1970s to only 4.5 percent in the 1990s.[1] It is imperative that Americans be encouraged to save more for their own personal retirement and to meet other personal goals, such as first home ownership, education of their children, and major health emergencies. Expanded IRAs and the ADS Account, in our judgment, will help encourage Americans to take the initiative to save for these significant events.

We are not suggesting that expanded IRAs will result in an immediate increase in the U.S. personal savings rate; however, it is a significant initiative to encourage individuals to increase their savings. I recognize that, based on my experience in the financial planning profession, for a few wealthier individuals, contributions to IRAs may serve as a substitution for other investments. It is also my experience, however, that a substantial number of middle income Americans will utilize tax-advantaged IRAs and the ADS Account to make new investments of funds that otherwise would be used for consumption.

The IRA program during the 1980s was very popular, particularly for middle income individuals. Once IRAs were restricted and the tax deductible features for most workers eliminated, many of these middle income individuals discontinued contributions for their personal savings. While some people attack IRAs as not contributing to new savings, the tax-advantaged IRA was in existence for such a short period of time that it is not possible to make reasonable judgments about their impact for the long term. It is our experience that tax-advantaged IRAs for everyone did change the savings habits of Americans and resulted in new savings.

We are also finding that company pension plans and social security benefits often are not enough to fund retirement needs. Furthermore, today many people find that their employers are having to cut back on their pension plan benefits and, in some cases, are forced to eliminate benefit plans.

The unprecedented uncertainty over the future now being experienced by middle income Americans is causing families to have concerns about their standard of living in their retirement years as well as an improved standard of living for their children and grandchildren. Expanded IRAs and the ADS Account can help middle income Americans become homeowners, send their children to college, support their aging parents, and support themselves in retirement as well as be a buffer for unexpected health care costs.

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[1] The Effectiveness of Savings Incentives: A Review of the Evidence by Dr. R. Glenn Hubbard and Dr. Jonathan Skinner, January 19, 1995, p. 1. A report publicly released on January 23, 1995 by the Securities Industry Association.

For these reasons, IAFP supports legislation to create more attractive personal savings vehicles. Expanded tax-advantaged savings options, such as those contained in the *American Dream Restoration Act, H.R. 6,* will greatly encourage our citizens to plan and to provide for their own financial futures. We are particularly encouraged by the potential of the ADS Account to provide citizens with a significantly better means of attaining their intermediate and long-term financial goals.

We also support enhancing traditional IRAs to provide incentives for Americans to save for their retirement. In this regard, we believe Congress should restore the up-front tax deduction on IRAs for all working Americans and increase the contribution limits for non-working spouses.

Attached as Exhibit 1 is a chart showing the benefits of a tax-advantaged IRA versus a non-IRA taxable investment over 30 years in five-year increments. The positive benefits of the IRA to provide increased income for retirement purposes is clear.

Exhibit 2 shows how a one-time $4,000 tax deductible IRA investment provides increased income versus a taxable investment.

CAPITAL GAINS TAX REDUCTIONS

IAFP also supports the capital gains reforms proposed in *Title I of H.R. 9, The Job Creation and Wage Enhancement Act,* part of the Contract with America. A 50 percent exclusion for long term gains and inflation indexing of assets would encourage capital formation, economic growth, job creation, and improved international competitiveness. It is important that capital be available to business, particularly venture capital for small businesses, for start-up and expansion purposes. Often, necessary capital for start-up companies and small businesses is available only at unreasonable terms or prohibitively high interest rates, if it is available at all. Many IAFP members serve clients who are small business owners who need access to affordable capital.

Capital gains tax reduction would benefit a broad spectrum of Americans. Lower capital gains taxes will help keep down the cost of capital and will free up money from "frozen assets" making it available for other investments, including providing the capital necessary for start-up companies and small businesses as referenced above. For example, many of my clients have chosen to hold onto securities and houses rather than suffer the consequences of a high capital gains tax. My experience is not unique; many of my colleagues could relate similar experiences.

CONCLUSION

We need to encourage increased savings and promote capital formation and investment in the United States. Enhanced IRAs, the American Dream Savings Account, and reduced capital gains taxes will contribute significantly toward these goals. We urge Congress to adopt legislation encouraging these savings and investment goals this year.

EXHIBIT 1

IRA vs. Non IRA Investment

	Original Investment 1/1/95	Value 1/1/00	Value 1/1/05	Value 1/1/10	Value 1/1/15	Value 1/1/20	Value 1/1/25
IRA Account							
Pre -Tax (1)	$4,000	$26,344	$62,582	$117,297	$197,692	$315,818	$489,383
Post - Tax (2)	$4,000	$17,741	$43,807	$82,108	$138,384	$221,072	$342,568
Taxable Investment (3)	$2,800	$16,535	$38,249	$73,848	$120,597	$181,985	$262,599

(1) Shows a $4,000 tax - deductible investment each year earning 8% per year.
(2) Shows the withdrawal value of the IRA account, assuming 30% tax rate, and no early withdrawal penalties.
(3) Shows the value of $4,000 in income which is set aside yearly in a taxable investmen account.

EXHIBIT 2

IRA vs. Non IRA Investment

	Original Investment 1/1/95	Value 1/1/00	Value 1/1/05	Value 1/1/10	Value 1/1/15	Value 1/1/20	Value 1/1/25
IRA Account							
Pre - Tax(1)	$4,000	$5,877	$8,636	$12,689	$18,644	$27,394	$40,251
Post -Tax(2)	$4,000	$4,114	$6,045	$8,882	$13,051	$19,176	$28,175
Taxable Investment(3)	$2,800	$3,677	$4,828	$6,340	$8,326	$10,933	$14,357

(1) Shows a one time $4,000 tax deductible investment earning 8% per year.
(2) Shows the withdrawal value of the IRA account, assuming a 30% tax rate, and no early withdrawal penalties.
(3) Shows the value of $4,000 in income, which is set aside in a taxable investment account.

Mr. THOMAS. Thank you very much, Mr. Jaffe.
Mr. Snyder.

STATEMENT OF JOEL B. SNYDER, VICE PRESIDENT FOR PROFESSIONAL ACTIVITIES, AND CHAIRMAN, U.S. ACTIVITIES BOARD, INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC., WASHINGTON, D.C.

Mr. SNYDER. Good afternoon, Mr. Chairman and members of the committee. I am Joel Snyder. I am a licensed professional engineer and a senior industry professor at the Polytechnic University in Brooklyn. I am also the owner of a small engineering consulting firm in Plainview, N.Y. I serve as the vice president for professional activities of the Institute of Electrical and Electronics Engineers, Inc. and am chairman of the IEEE–U.S. Activities Board.

With me today is George McClure of Orlando, Fla. Mr. McClure is an engineer, recently retired from a major aerospace firm and chairman of the IEEE–USA's Career Policy Council. We are pleased to appear before the committee to present IEEE–USA's views on the savings incentive provisions in section 4 of the American Dream Restoration Act, H.R. 6.

The IEEE is a transnational professional society and its U.S. Activities Board promotes a technology policy and professional interests of our 240,000 U.S. members. I will present a summary of our written statement that has been submitted for the record.

IEEE members and other engineering, scientific and technical professionals are very encouraged by the growing national consensus that many of the country's most important long-term economic problems are directly related to declining rates of investment and personal savings in the United States. Our primary concern is a decline of domestic investments in recent years.

Personal savings has also declined precipitously. Changes in tax policy are urgently needed to boost savings and investment. IEEE–USA calls for adoption of tax policies that will encourage businesses to take a longer term view of return on investments. We also support an improvement and expansion of tax incentives that will increase personal savings for productive investment in the Nation's economy.

Tax-deductible IRAs have long been one of the most effective of these incentives, especially for working Americans without employer-sponsored pensions. Personal savings are critically important, not only for economic growth and job creation, but to provide greater financial security for American workers and their families. Effective incentives to save are absolutely essential if our economy is to continue to grow and middle-income workers and their families are to be able to realize the American dream.

As we understand it, H.R. 6 will permit individuals to make nondeductible posttax contributions regardless of their income, pension or income tax status. In addition, moneys held for at least 5 years can be withdrawn without tax or penalties, provided they are used to help pay for retirement, first-home, postsecondary education expenses or major medical costs.

Other than providing easier access and greater flexibility in the use of account balances, proposed ADSAs offer few, if any, advantages over other nondeductible posttax savings incentives. Because of their proven effectiveness as a stimulus to increased personal savings, IEEE–USA strongly supports the expansion of opportunities for average Americans to make tax-deductible contributions to individual retirement accounts, irrespective of their income, and irrespective of their pension participation or tax filing status. By providing immediate tax relief, tax deductibility offers a much greater incentive for individuals to save than nondeductible vehicles.

IEEE–USA is convinced that an expanded, frontloaded IRA will stimulate much more in new savings than the proposed backloaded ADSA. The needed incentive to increase personal savings can best be provided by eliminating current income ceilings and eligibility to make tax-deductible IRA contributions.

With downsizing by big businesses and outsourcing of work to small businesses and independent contractors, more and more workers will have to provide for their own retirement without the benefit of traditional employer-sponsored pension plans. Financial planners seem to agree that at least 70 percent of income is needed for retirement. IRA contribution limits must therefore be increased and increased substantially. We recommend that contribution limits of $5,000 for individuals and $10,000 for couples be established, at least for taxpayers who are not eligible to participate in employer-sponsored pension plans.

IEEE–USA also recommends that Congress substitute a low-interest loan provision for the penalty-free withdrawal option.

By linking easier access to repayment obligation, a loan provision will permit contributors to use their savings for purposes other than retirement while providing additional incentives for long-term savings retention rather than consumption.

An improved IRA will increase savings and will hold savings for a longer term because there would be no tax-free withdrawals. The new improved IRA will also generate more tax revenue when cashed out than the nondeductible ADSA.

We have prepared an example that demonstrates the advantages of a deductible IRA. With loan provisions, instead of penalty-free withdrawal it will result in increased savings, increased tax revenues, and greater preservation of assets for retirement.

I thank you.

[The prepared statement and attachment follow:]

TESTIMONY OF JOEL B. SNYDER
INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC.

Good Morning, Mr. Chairman and Members of the Committee. I am Joel Snyder. I am a Licensed Professional Engineer and a Senior Industry Professor at the Polytechnic University in Brooklyn. I am also the owner of a small engineering consulting business in Plainview, New York. I am the Vice President for Professional Activities of the Institute of Electrical and Electronics Engineers, Inc. and Chairman of IEEE's United States Activities Board.

With me today is George McClure of Orlando, Florida. Mr. McClure is an engineer, recently retired from a major aerospace firm, and Chairman of IEEE-USA's Career Policy Council. He also serves on IEEE's Individual Member Benefits and Services Committee as well as IEEE-USA's Engineering Employment Benefits Committee.

We are pleased to appear before the Committee to present IEEE-USA's views on the savings incentives provisions in Section 4 of the American Dream Restoration Act (H.R. 6).

IEEE-USA'S INTEREST IN SAVINGS INCENTIVES

The Institute of Electrical and Electronics Engineers, Inc. (IEEE) is a transnational professional society whose 320,000 members live and work in more than 130 countries throughout the world. IEEE's United States Activities Board promotes the technology policy and professional careers interests of IEEE's 240,000 U.S. members.

IEEE members, and other engineering, scientific and technical professionals, are very encouraged by the growing national consensus that many of the country's most important long term economic problems are directly related to declining rates of domestic investment and personal savings in the United States. We are hopeful that actions by the new 104th Congress will help to reverse these alarming trends.

Of primary concern is the decline in domestic investment in the United States. Recent statistics indicate that net private domestic investment, which averaged 7.4 percent of gross domestic product (GDP) between 1960 and 1980, has dropped from 5.5 percent of GDP in the early 1980's to 3 percent since 1991 - an alarming 59 percent reduction!

Personal savings has also declined precipitously. The personal savings rate has dropped from 5.6 percent of GDP between 1981 and 1985 to 3.4 percent today - a 40 percent reduction in the last 10 years! We are currently saving half as much as Germans and only 25 percent as much as the Japanese. If these trends continue, economists predict that there won't be enough savings to sustain a sufficient level of investment into the next century.

Changes in tax policy are urgently needed to boost personal savings and stimulate private domestic investment. We're very pleased that the Ways and Means Committee is devoting so much time to these critically important problems during the first 100 days of the 104th Congress.

IEEE-USA's current Federal Legislative Agenda calls for adoption of tax policies that will encourage businesses to take a longer-term view of return on investment and help to boost domestic investment in research and development. We also support the improvement and expansion of tax incentives that will increase personal savings for productive investment in the nation's economy. Tax-deductible IRAs have long been one of the most effective of these incentives, especially for working Americans without employer-sponsored pensions.

Personal savings are critically important, not only for economic growth and jobs creation, but to provide greater financial security for American workers and their families. Economic globalization, increasing foreign and domestic competition, and the end of the Cold War have been accompanied by wave after wave of downsizings by major corporations. Outsourcing of manufacturing, service and administrative jobs to part time, temporary and other kinds of contingent workers are changing the nature of employer-employee relationships throughout the economy. Real wages for most middle income Americans, including many engineers and scientists, continue to decline at the same time that housing, education, medical care and other basic necessities are becoming more and more expensive. All of these trends are making it harder and harder to save for retirement and other important purposes.

Personal savings and effective incentives to save are absolutely essential if the economy is to continue to grow and middle income workers and their families are to be able to realize the American Dream.

AMERICAN DREAM RESTORATION ACT PROVISIONS

As we understand it, the American Dream Restoration Act (H.R. 6) will permit individuals, including non-working spouses, to make non-deductible (post-tax) contributions of up to $2,000 ($4,000 for couples) to new IRA-like American Dream Savings Accounts (ADSAs), regardless of their income, pension or income tax filing status. In addition, monies held for at least five years can be withdrawn without tax or penalties provided they are used to help pay for retirement, a first home, post-secondary educational expenses or major medical costs, including long term care.

Other than providing for easier access to and greater flexibility in the uses that can be made of account balances, the proposed ADSAs offer few, if any, advantages over other non-deductible (post-tax) savings incentives that are currently available to taxpayers.

IEEE-USA COMMENTS AND RECOMMENDATIONS

1. Make Contributions Tax Deductible

Because of their proven effectiveness as a stimulus to increased personal savings by individuals and the accumulation of capital needed for productive investment in the nation's economy, IEEE-USA strongly supports the expansion of opportunities for individual Americans to make tax-deductible contributions to Individual Retirement Accounts, irrespective of their income, pension participation or tax-filing status.

Much more savings will result if all contributions, within certain stipulated dollar limits, are made tax-deductible. Such a change will also provide a positive incentive that will encourage more taxpayers to become savers.

In 1981, for example, 3.4 million taxpayers put $4.8 billion into IRAs. In 1982, after eligibility requirements were liberalized, the number of IRA contributors jumped to 12 million and their savings to $28.3 billion. In 1986, 16.2 million taxpayers made $38.2 billion in IRA contributions. When stricter eligibility requirements were re-established in 1987, the number of contributors dropped to 7.3 million. Contributions fell to $14.1 billion - a 63 percent decline in a single year!

By providing immediate tax relief, tax-deductibility offers a much greater incentive for individuals to save than non-deductible vehicles can ever do. Based on the experience of our own members, IEEE-USA is convinced that an expanded "front-loaded" IRA will stimulate much more in new savings than the proposed "back-loaded" ADSA.

2. Remove Income Eligibility Ceilings

The needed incentive to increase personal savings can best be provided by eliminating current income ceilings on eligibility to make tax-deductible contributions to Individual Retirement Accounts.

3. Expand Allowable Contribution Limits

With downsizing by big businesses and outsourcing of work to small businesses and independent contractors, more and more workers are faced with the challenge of having to provide for their own retirement without the benefit of traditional employer-sponsored pension plans. According to financial planners, IRA assets and Social Security should be capable of replacing up to 70 percent of pre-retirement income. To accomplish this objective, IRA contribution limits must be increased - and increased substantially.

Just to compensate for the adverse affects of inflation on their purchasing power since they were first established in 1981, the current $2,000 contribution limits should be boosted to $3300.

We recommend that contribution limits of $5,000 for individuals (and $10,000 for couples) be established - at least for taxpayers who are not eligible to participate in employer-sponsored pension plans or other voluntary, salary reduction savings arrangements where thay work.

4. Substitute Loan Provisions for Penalty-Free Withdrawals

In order to prevent the American Dream from becoming a nightmare as more and more middle income savers approach retirement, IEEE-USA also recommends that Congress substitute a low-interest loan provision for the penalty-free withdrawal option featured in current IRA reform proposals, and the American Dream Restoration Act.

By linking easier access to a repayment obligation, a loan provision will permit contributors to use their savings for purposes other than retirement while providing an additional incentive for long term savings retention rather than consumption.

SUMMARY AND CONCLUSIONS

Compared with the after-tax and penalty-free withdrawal features in the proposed American Dream Savings Account, an improved Individual Retirement Account, with tax-deductible contributions and fully taxable proceeds, including the interest earned on account balances, will provide a very powerful incentive for individuals to increase their personal savings. Such an incentive will also generate considerably more tax revenue when the accounts are eventually cashed out.

The simple example that we have prepared for inclusion in the hearings record demonstrates that an expanded, tax-deductible IRA will generate considerably more in the way of benefits for savers as well as tax revenue for the Treasury than the non-deductible ADSA proposed in the American Dream Restoration Act.

- End -

IEEE-USA
DEDUCTIBLE VS NON-DEDUCTIBLE SAVINGS INCENTIVES
January 31, 1995

Attachment A

The following example is intended to demonstrate the advantages of front-ended (tax-deductible) savings incentives over the back-loaded (non-deductible) option proposed in the American Dream Restoration Act.

Tom, a 25 year old (in the 28% tax bracket) wants to save for a down payment on a house. Assuming 3-4% inflation per year, the average price for a new home will be $120,000 in 1999. A 10% downpayment will require $12,000. If Tom starts saving $2,000 a year in 1995 in a non-deductible account that pays 10%, he will accumulate $12,210 in the account by 1999. Although he will have paid $2800 in taxes on the $10,000 as it was deposited in the account, $2210 in interest earnings will escape taxation when the account is withdrawn for the home purchase.

Tom's 25 year old brother Bob elects to save $2,000 a year on a tax-deductible (pre-tax) basis. In seven years, he will accumulate $18,974 in a 10% interest bearing account. When he withdraws the money, he will pay $5312 in taxes (at 28%), leaving $13,667 to apply toward his first home purchase.

After buying his first home at age 32 and having become used to saving $2,000 a year on a tax-deductible basis, Bob starts saving for his children's college education. If he saves $2,000 a year in an account that pays 10%, his college fund will grow to $49,000 in 13 years. If he takes the money out, he will pay $13,730 in taxes (at 28%) and have $35,310 left to help pay for college educations.

Bob's brother Tom, who bought his house at age 30, also saves for college, but over a 15 year period via after-tax contributions to his back-ended account. Tom's college account will grow to $63,500. He will have paid $8,400 in taxes on the $30,000 he deposited in the account, leaving the $33,500 in interest earnings to escape taxation.

The total tax liability for these two cases (assuming a 28% income tax bracket) can be summarized as follows:

Examples	Post Tax Case (Back-Loaded)	Pre-Tax Case (Front-Loaded) Account)
5 years; first home	$2,800	
7 years; first home		$5,312
15 years; college	$8,400	
13 years; college		$13,730
Total Tax Receipts	$11,200	$19,042

In the tax deductible (front-loaded) option, the tax liability can be deferred further by borrowing the money from the account, at a low rate of interest, rather than withdrawing the money. Interest payments on the loan will further increase the size of the account and therefore the amount of the tax ultimately paid.

The goal is to provide appropriate incentives to savers to:

1) Increase his/her savings rate with the help of tax deferral on the contributed amount,

2) Encourage replacement of funds borrowed from the account for other important purposes before retirement, thereby helping to ensure that the funds will be there when needed for retirement,

3) And, coincidentally, increase the total amount of tax revenue ultimately paid on the proceeds of this account, normally when it is cashed in at retirement following the procedures now used for IRAs.

Mr. THOMAS. Mr. Kelly.

STATEMENT OF W. THOMAS KELLY, PRESIDENT, SAVERS & INVESTORS LEAGUE

Mr. KELLY. Thank you, Mr. Chairman. I am Thomas Kelly, the president of the Savers & Investors League. I thank you for inviting me to comment on those provisions of the Contract With America that are designed to encourage savings and investment.

The league's views may be summarized by three important points:

First, we support the Contract's American dream savings provision. It is certainly a move in the right direction. However, in our view, these provisions do not go far enough. Legislation should be adopted promptly to fully remove the ordinary income tax bias against savings. This cancerous tax bias is constant and progressive. It is a drain on the fiscal soundness of our government and on the economic growth of our Nation.

This tax bias must be removed totally. This total removal is accomplished by first allowing unlimited tax deductions and tax deferral of IRA-type saving.

Second, income taxes should be imposed only on any planned withdrawal at then-existing progressive income tax rates like wages.

And third, there should be no penalty taxes nor forced distributions at any time.

These three simple basic criteria are embodied in the bipartisan Individual Investment Account Act, H.R. 328, as sponsored by Mr. McCrery of this committee, and by S. 159 as sponsored by Senator Breaux of the Finance Committee.

Our second important point is that no consideration of how to improve our Nation's rate of saving can ignore the staff procedures for measuring alleged tax expenditure costs of IRAs. These staff procedures are so flawed that the committee's tax policy considerations are seriously compromised.

Even the Treasury Department's 1995 budget document for the first time ever disclosed that tax expenditure figures for IRAs were overstated by over three times when measured on a more rational, realistic basis. And even these severely reduced costs continued to reflect the self-defeating, second layer of tax on saving that should not be imposed upon our government, on our taxpayers, or on our Nation.

Much debate arises over static versus dynamic scoring of the alleged costs of IRA-type plans. Static scoring stands logic and sound tax policy on its head.

For example, it assumes that IRA tax deductions are an expense rather than creating a government asset. The dynamic scoring of IRAs is fiscally sound and entirely appropriate.

The dynamic scoring of H.R. 328 by well-respected economists shows that tax receipts grow quickly and become progressively larger each year over those otherwise collected under the ordinary income tax on saving. These increasing tax receipts reflect a growth in saving, in production, in GDP, and in jobs, and a resulting reduction in the cost of capital brought about by unlimited tax-deductible saving. And because of the gains arising from increased capital flow in very large measure to labor, it is estimated that unlimited tax-deductible investment accounts will increase middle-income taxpayers' aftertax income by 12 to 23 percent within 6 or 7 years following enactment.

Our third important point is to recognize that unlimited, tax-deductible IRA-type plans are not tax loopholes for the rich. The full removal of the tax bias against savings not only restores the taxation of saving to one of proper neutrality in terms of saving versus consumption; it is also neutral in regard to the taxation of realized capital gain versus the taxation of dividend and interest income.

Unlimited, tax-deductible, tax-deferred saving is not a favoring of savers in any tax bracket. It is one of restoring fiscally sound tax neutrality to all tax brackets.

In summary, a removal of only a portion of the tax bias against saving, as found in the Contract's American dream savings legislation, is only a partial correction of the tax bias against saving when a full correction, as found in H.R. 328, is both imperative and sound. The unlimited, tax-deductible individual investment accounts of H.R. 328 are tax revenue gainers, not losers. Thus, there is no reason, other than an irrational, existing, static scoring dogma, to deny our Nation, including all taxpayers and our government, the singular advantages that will flow from this sound legislation.

The league urges the committee to thoroughly explore the economic growth and the rational tax revenue implications of H.R. 328.

I will be pleased to respond to any questions. Thank you.

[The prepared statement and attachments follow:]

WRITTEN TESTIMONY OF
W. THOMAS KELLY
PRESIDENT, SAVERS & INVESTORS LEAGUE
ON JANUARY 31, 1995
BEFORE THE WAYS & MEANS COMMITTEE
ON SAVINGS AND INVESTMENTS

Mr. Chairman, and members of the Committee. I thank you for your invitation to testify on the Contract With America provisions that are designed to encourage greater saving and investing. We support these goals. However, it is our strong view that the Contract does not go far enough to properly correct the existing, extremely serious tax bias against saving.

Others on this panel, as well as many other panels in many other Congresses, have made proper, impassioned pleas for Congress to restore and expand tax-deductible IRAs, as well as to reduce the negative impact of the capital gains tax on saving and investing. Basically, these pleas have been shunted aside by Congress for two erroneous reasons: (1) the allegation that they cost too much in lost tax revenue; and (2) they're perceived by some as tax loopholes for the rich.

In the League's judgment, both of these arguments are totally specious. These arguments are contrary to the government's own fiscal interests, as well as being contrary to the taxpayer's, and our nation's, financial well-being. Further, removing the income tax bias *against* saving does *not* mean that such removal is biased *for* saving. The resulting taxation becomes "neutral."

It is important to state at the outset that all economists agree that the ordinary income tax is biased against saving. The question is—how much bias? Is this bias harmful? To help understand this bias and its magnitude, Table 1 utilizes two tax brackets to better illustrate the impact of the ordinary income tax on saving, and how this cancerous tax eats away at the government's tax revenue. An actual mutual fund was used for this factual illustration.

<u>The Impact of Income Tax Bias On Tax Revenues</u>

- In Table 1, two taxpayers' $100 of income (wage) were taxed at 15% or 50%, respectively. The after-tax balance ($85 and $50) was invested in the mutual fund. Each end-of-year fund distribution was taxed to the taxpayer as shown, with the balance reinvested. This investment was maintained from 1926 to 1992, for a sixty-seven year duration. The investment and tax impact during similar durations in the future will not reflect a significant difference from those portrayed herein. Thus, the past is prologue.

Table 1

Ordinary Income Tax Revenues Derived From
$100 OF PRE-TAX INCOME
That's Saved And Invested In A Typical Mutual Fund On January 1, 1926
And Maintained For 67 Years Until Sold On 12/31/92

Year	Duration	Tax Revenues From Taxpayers In The 15% Tax Bracket (a)	Tax Revenues From Taxpayers In The 50% Tax Bracket (b)	Govt.'s Revenue Gain Or (Loss) From Taxpayer In Higher Tax Bracket (c = b - a)
1926*	1	$15.90	$51.77	$35.87
1927	2	.77	1.47	.70
1928	3	.98	1.86	.88
1929	4	1.22	2.28	1.06
1930	5	1.25	2.32	1.07
1931	6	1.30	2.37	1.07
1932	7	1.14	2.03	.89
1933	8	.81	1.41	.61
1934	9	.79	1.36	.58
1935	10	.80	1.38	.58
1936	11	11.34	19.37	8.03
1937	12	2.69	4.31	1.62
1938	13	4.26	6.68	2.42
1939	14	2.02	3.08	1.05
1940	15	2.01	3.01	1.00
1941	16	2.26	3.34	1.08
1942	17	2.31	3.35	1.04
1943	18	2.18	3.11	.93
1944	19	5.68	7.99	2.32
1945	20	11.56	15.88	4.31
1946	21	15.51	20.48	4.97
1947	22	5.68	7.09	1.41
1948	23	5.50	6.72	1.23
1949	24	11.02	13.23	2.21
1950	25	9.94	11.57	1.63
1951	26	20.22	22.98	2.77
1952	27	23.29	25.46	2.17
1953	28	11.97	12.56	.59
1954	29	20.65	21.22	.57
1955	30	33.11	33.10	0.00
1956	31	41.79	40.22	(1.57)
1957	32	23.43	21.54	(1.88)
1958	33	19.42	17.35	(2.07)
1959	34	32.14	28.23	(3.91)
1960	35	26.91	23.01	(3.90)
1961	36	39.87	33.36	(6.52)
1962	37	34.11	27.82	(6.29)
1963	38	40.32	32.09	(8.23)
1964	39	39.67	30.80	(8.87)
1965	40	44.46	33.78	(10.68)
1966	41	45.19	33.63	(11.57)
1967	42	73.44	53.51	(19.93)
1968	43	70.98	50.31	(20.67)
1969	44	67.51	46.74	(20.77)
1970	45	46.09	31.14	(14.95)
1971	46	62.68	41.61	(21.07)
1972	47	74.23	48.29	(25.95)
1973	48	54.43	34.69	(19.75)
1974	49	37.19	23.26	(13.94)
1975	50	42.71	26.24	(16.46)
1976	51	55.02	33.31	(21.71)
1977	52	62.72	37.39	(25.33)
1978	53	74.29	43.50	(30.79)
1979	54	96.20	55.26	(40.94)
1980	55	99.28	55.94	(43.33)
1981	56	179.88	99.75	(80.13)
1982	57	130.99	70.49	(60.50)
1983	58	207.13	109.31	(97.82)
1984	59	325.49	167.33	(158.16)
1985	60	278.81	137.48	(141.34)
1986	61	465.32	223.27	(242.05)
1987	62	415.83	191.39	(224.44)
1988	63	465.41	206.82	(258.60)
1989	64	567.02	243.00	(324.01)
1990	65	612.82	253.88	(358.94)
1991	66	590.02	235.40	(354.61)
1992#	67	2,885.25	1,443.79	(1,441.46)

* Includes the 1926 tax on income

\# Includes the 1992 tax on realized gain when the fund is sold

- Note that the long string of government tax collections from saving would never have occurred if the taxpayers had consumed (spent) their $85 or $50 net-after-tax income. It is this second tier of year after year taxation that produces the income tax bias against saving.

- Obviously, the taxes collected each year bounced around from year to year. This reflects the investment climate of the times, as the U.S. went through good times and bad times, including the worst depression and World War II.

- Note that as time went on, the expected larger tax revenues each year from the high bracket taxpayer vs. the low bracket taxpayer gradually narrowed. This narrowing spread of tax revenues from the higher and lower tax bracket taxpayers continued until the 30th year. *From that point forward, the government increasingly collected more tax revenue from the 15% bracket taxpayer then from the 50% bracket taxpayer!*

  These tax revenue losses from the high bracket taxpayer vs. the low bracket taxpayer continued to grow progressively from year to year, and culminated in an even larger loss when each taxpayer sold their fund in the 67th year, and the investment's unrealized gain was realized and taxed.

<u>Valid Conclusions To Be Drawn From Table 1</u>

- The income tax bias against saving is shocking. The longer you save, the worse it becomes, and the government's tax base related to saving gets smaller.

- There is no escape. Selling one investment to buy another usually triggers more tax. Thus, the government's tax base is reduced from that point forward, forever. And, the ever-diminishing tax base, over what it would be otherwise, is effectively passed on from one taxpayer to another as savings and investments are transferred.

- Don't be misled by the fact that when taxes are paid, the related savings or investment may or may not be liquidated to pay the tax. The source of funds to pay the tax may come from elsewhere. Regardless, the capital that's otherwise available for future taxation is reduced by the amount of the tax.

- By increasing tax rates on saving to escape this tax receipts dilemma, the government wipes out its tax base faster, thereby eventually collecting less and less tax revenue.

- This tax bias against saving occurs regardless of whether the return on saving is interest, dividends, or realized capital gain.

- Is it any wonder that our taxpayers and our government increasingly feel that they're on a fiscal treadmill that's always accelerating without forward progress? They are! Raising income tax rates on saving only makes the treadmill move faster, and the problem gradually gets worse.

- Taxpayers may come and go, but their year-by-year losses of capital due to the income tax on saving can never be replaced. Thus, the government's tax base related to saving perpetually shrinks from what it would otherwise be if this pernicious and needless tax bias were not present. Is it any wonder that governments gradually fail due to fiscal exhaustion? Ratcheting up taxes on saving only hastens the demise. *Think about it.*

If the facts in Table 1 don't make your hair stand on end, what happens to taxpayers' saving under the ordinary income tax will make your hair curl. See below.

The Impact of the Income Tax Bias On Saving

Having observed how taxes gradually gnawed away at the government's tax base over the past sixty-seven years, let's look at how each taxpayer's investment fared under the ordinary income tax over the same period of time.

Table 2

Taxpayers' After-Tax Mutual Fund Values On 12/31/92

15% Taxpayer	50% Taxpayer
$49,052	$4,598

In order to evaluate the impact of the income tax that created these after-tax values, it is proper to measure the value of each taxpayer's $100 of pre-tax income if it could have been invested in the mutual fund *without any tax*. This value then becomes a proper benchmark value against which the impact of any tax methodology may be measured.

Table 3

Benchmark Values

Each Taxpayer's Mutual Fund Values On 12/31/92 From $100 Investment Without Tax	$120,649

When one measures the taxpayers' after-tax values in Table 2 vs. the Benchmark Values of Table 3, each taxpayer's values are the following percentage of Benchmark Values (Table 2 ÷ Table 3):

Table 4

After-Tax Values As A % Of Benchmark Values

15% Taxpayer	50% Taxpayer
41%	4%

In short, the 15% taxpayer lost 59% of his benchmark values due to the ordinary income tax. That's four times his tax bracket! The 50% taxpayer lost 96% of his benchmark values! Such tax bias against saving amounts to outrageous, idiotic confiscation worthy of tax revolt! *It must be stopped immediately!* The tax grievances leading to the Boston Tea Party pale in comparison.

Clearly, the ordinary income tax is grossly biased against saving. If these taxpayers hadn't saved, their after-tax spending would have been 85% and 50% of their before-tax income, respectively, not 41% and 4% of their unbiased, benchmark values. Not only are taxpayers grievously abused by this income tax on saving, as shown above, the government's own tax base is needlessly and scandalously whittled away by the ordinary income tax, as shown in Table 1.

Tax-Deductible IRA-Type Plans

Now, let us measure the tax treatment of tax-deductible IRA-type plans.

Table 5

$100 Of Pre-Tax Income
That Is Deducted As An IRA Contribution
And Invested In A Mutual Fund On January 1, 1926

	15% Taxpayer		50% Taxpayer	
	$	%	$	%
Mutual Fund IRA Values On 1/1/26	$120,64 *	100%	$120,649 *	100%
Tax Upon 12/31/92 Withdrawal	$18,097	15% (a)	$60,324	50% (a)
Taxpayers' After-Tax Values	$102,552	85% (b)	$60,325	50% (b)

* Equals the Benchmark Values in Table 3

From the above you will note that—

- *Each* dollar saved and deducted by each taxpayer on 1/1/26 grew, without tax, to $1,206 by 12/31/92.

- Upon the IRA withdrawal, the government not only recaptured its tax that was deferred on 1/1/26 (i.e., $15 and $50, respectively), the government also received the full free-market investment growth on these deferrals, i.e.—

Table 6

Government Tax Collections On 12/31/92

15% Tax Bracket Taxpayer:	$15 x $1,206 = $18,097	See (a) above
50% Tax Bracket Taxpayer:	$50 x $1,206 = $60,324	See (a) above

- Note that the taxpayers effectively contributed $85 and $50 out of their *own* pocket to their tax-deductible IRAs. The remaining part of the $100 contribution (i.e., $15 and $50) represented the government's deferred tax. Thus, upon withdrawal on 12/31/92, the taxpayers received *their portion* of the IRA contribution ($85 & $50), plus the full investment growth thereon, *without further tax*. For example—

Table 7

Taxpayers' After-Tax Values On 12/31/92

15% Tax Bracket Taxpayer:	$85 x $1,206 = $102,552	See (b) above
50% Tax Bracket Taxpayer:	$50 x $1,206 = $60,324	See (b) above

- It is important to recognize that tax-deductible saving is *neutral* taxation, and it is fair to all taxpayers, regardless of their tax bracket. Each taxpayer defers otherwise taxable income. This tax deferral is subsequently taxed upon a withdrawal, at which time it is taxed at progressive, ordinary income tax rates. What is avoided is the senseless, self-defeating second layer of ordinary income tax that's imposed on the taxpayer's investment income and realized gain.

- With tax-deductible IRA-type plans, all taxpayers effectively enjoy a *zero* tax rate on *their own portion* of their contribution to the IRA, e.g., the $85 and $50 illustrated above. This is the same amount that would have been consumed (spent) if it had not been saved via the tax-deductible IRA-type plan. Thus, for this "spending" amount that is saved and invested, tax-deductible IRAs produce a zero tax on realized capital gain and a zero tax on dividend and interest income. This is proper, neutral taxation, and every taxpayer, regardless of tax bracket, is treated fairly.

  Surely, too, and properly so, unlimited, tax-deductible IRA-type plans are more favorable, simpler, and more fiscally sound than reducing the capital gains tax and indexing the asset basis for inflation. While reducing the capital gains tax is also very appealing and very sound, such a partial removal of the income tax bias against such saving is not the best course to follow.

Measuring The Cost Of IRAs

Government tax policy is driven by staff revenue estimates. IRAs are staff-labeled as "tax-expenditures" and staff-described as being "most similar to those direct spending programs which have no spending limits, and which are available as entitlements to those who meet the statutory criteria established for the programs." They liken it to Medicare, Social Security, etc.! *Nothing could be more inaccurate than those staff descriptions!*

IRA-type tax deductions are not "spendings," they're voluntary savings! The government's tax analysis faces 180° in the wrong direction! This leads to Committee decisions and government tax policy that is also faced 180° in the wrong direction!

As illustrated with tax-deductible IRA-type plans, the government gets back every nickel of the tax deduction, plus growth thereon, at free-market rates of total return! The alleged revenue loss the government incurs is the second layer of tax that it should not impose in the first place, because it is progressively destructive to the government's tax receipts and imposes confiscatory taxation on all taxpayers who save! *And "saving" is the life blood of any progressive civilization.*

Even the government's 1995 Budget document demonstrates that its "tax expenditure" revenue estimates for tax policy deliberations are grossly misleading. For example:

Table 8

U.S. Budget Analytical Perspectives—Fiscal Year 1995
(pages 59-61)

1994 Tax Expenditure Loss From IRAs

1994 Tax Expenditure	$5.415 Million
*Discounted Present-Value Of The Above Tax Expenditure	1.735 Million

*This figure had never been disclosed before

The above $5.4 million IRA tax expenditure corresponds to the Joint Committee on Taxation figures that are used by the Ways & Means Committee in their tax policy deliberations. However, the *present-value figure* reflects the more realistic fact that all IRA tax *deductions* are recovered by the government with free-market rates of growth thereon! In effect, therefore, the government admits that its tax expenditure figures used for Committee tax policy deliberations are over three times too high when measured on a more realistic basis ($5.4 ÷ $1.7 = $3.3)! Further, the $1.7 million present-value figure represents the senseless and self-defeating second layer of tax that should never be imposed in the first place.

A few years ago, a highly respected Washington, DC, actuary analyzed the government's methodology in determining tax expenditures relating to tax deferred saving. His conclusion was "...these tax expenditure facts are conceptually flawed, arbitrary, and almost useless for budget purposes...Any tax law based on such arbitrary and capricious figures can only be good by accident." Amen.

In short, universal, unlimited, tax-deductible saving (as found in the bipartisan H.R. 328, the Individual Investment Account Act) totally removes the income tax bias against saving. It is very important to recognize and accept the fact that such tax-deductible saving represents *neutrality* in regards to the basic taxpayer decision of whether to "save" or "consume" income. Thus, the removal of the tax bias against saving via H.R. 328, *does not* mean that such removal favors saving over consumption; it *does not*, it is neutral.

Clearly, when the question is raised as to the cost of enacting tax-deductible saving legislation, the paramount question is quite different—namely, what's the cost of the existing, unrelenting fiscal drag on the economy that arises from the existing tax bias against saving? Common sense and rational tax revenue estimation clearly show that eliminating the income tax bias on saving can only be positive, not negative, legislation.

The Tax Revenue Impact of Unlimited, Tax-Deductible Saving
As Proposed in H.R. 328

The League strongly supports H.R. 328 (and S. 159, its companion bill in the Senate) that provides for universal, unlimited, tax-deductible IRA-type "investment accounts." This legislation also includes the removal of other senseless biases against saving usually found with existing IRAs, such as penalty taxes, forced distributions, etc. See the summary of H.R. 328, attached.

To illustrate the fiscal impact of H.R. 328, the well-known and respected economics advisory firm, Fiscal Associates, in 1993 prepared an economic forecast of the revenue aspects of H.R. 328 on two bases: *static* (government method) and *dynamic* (a far more rational method for measuring the impact of taxes on saving).

Table 9

Estimated Static Revenue Losses And Dynamic Revenue Gains
From Universal, Unlimited, Tax-Deductible IRA-Type Plans

BILLIONS OF DOLLARS

Years	Static Revenue (Loss) (a)	Dynamic Revenue Gains (b)	Net Dynamic Federal Tax Gains & (Losses) (c = a + b)	Net Present-Values Of Gains (Losses) Discounted @ 11.6%* Net Dynamic Tax Revenue (d)	GDP (e)
1995	$ (28)	$ 18	$ (10)	$ (23)	$ 121
2000	(67)	69	2	(31)	916
2010	(146)	178	32	11	2,830
2020	(288)	370	82	57	4,186
2030	(567)	762	195	95	5,076
2040	(1,115)	1,571	456	124	5,661
2060	(4,314)	6,677	2,363	164	6,297

*The above net present-value calculations assume a discount rate of 11.6 percent—the estimated rate of return to society given by a long-term return on mutual funds. The favorable swing (i.e., loss to gain: -b to +a) in estimated revenues is mind-boggling (e.g., $136 billion in year 2000)! A copy of the complete Fiscal Associates report is available to you upon request.

Fiscal Associates' forecasted results also portray a dramatic increase in taxpayers' after-tax income and related standard of living that will flow from the prompt enactment of H.R. 328.

Table 10

How Universal, Unlimited, Tax-Deductible IRAs
Will Increase After-Tax Incomes In the Year 2000

Adjusted Gross Income *	Percent Change In After-Tax Income
Under $5,000	.2%
$5,000 - $10,000	3.4%
10,000 - 20,000	13.6%
20,000 - 30,000	19.3%
30,000 - 40,000	12.4%
40,000 - 50,000	12.3%
50,000 - 100,000	23.3%
100,000 - 200,000	6.3%
200,000 - 500,000	3.3%
500,000 or more	5.8%

* Adjusted gross income as currently defined

Note how middle-income America will enjoy the bountiful fruits of unlimited, tax-deferred saving and free-market enterprise that flows from unlimited, tax-deductible saving via the enactment of H.R. 328.

The above positive fiscal results can not be ignored by Congress, nor the public. While there may be differences among economists as to the efficacy of dynamic vs. static scoring and the underlying assumptions and methods, the "dynamic" results are not only dramatically favorable, *they do reflect common sense and a far more rational method of estimating the program's fiscal results.*

H.R. 328 is bottomed on plain common sense and reflects the economic facts of life that when you reduce the costs of saving, you get more of it. Further, H.R. 328 induced-saving is always measurable and held in trust for productive, free-market investment that will grow to everyone's advantage, including the government's, as it collects its taxes on the enhanced values at ordinary income tax rates when benefits are paid. Compounding this tax collection growth are the added taxes arising from enhanced GDP and the broadbased increase in taxes generated thereby.

It is important to recognize that unlimited, tax-deductible saving *without* penalty taxes, forced distributions, and no income nor estate tax at death, will greatly increase the propensity of most taxpayers to save increasing amounts over that which they would save under the biased-against-saving ordinary income tax. New saving and increased saving have no offsets to eventual government tax receipts, because, by definition, these amounts of saving would have otherwise been spent, thereby forgoing any further enhanced tax receipts by the government via personal, free-market investment growth.

Similarly, to the extent that the "new saving" portion of a taxpayer's tax-deductible contribution matches or exceeds his or her tax bracket (e.g., when 15% or more of the tax-deductible contribution represents *new* saving for a 15% tax bracket taxpayer), that new saving portion will match or exceed the government's borrowing that's needed to replace the temporary loss of revenue from tax deferral. Thus, net national saving is maintained or enhanced.

Conclusion

There is no rational reason to defer an aggressive Congressional push to enact universal, unlimited, tax-deductible saving as proposed by H.R. 328. To the extent that existing budgetary rules, or precedents for tax revenue estimation methods, if any, appear to impede the consideration and enactment of H.R. 328, it is most appropriate to very seriously consider their inapplicability and their inappropriateness to this legislation. Surely, sound, vital legislation that increases personal saving within the U.S., as well as the government's tax revenue receipts derived therefrom, must not be held hostage to rules and precedents that are inappropriate and self-defeating to all concerned, including the government.

The 1994 election reflects a strong voter/taxpayer demand for a bipartisan government to be bold and sensible in removing the dead-weight burden of irrational, self-defeating government from their backs. The anti-saving bias of the ordinary income tax is a classic example of faulty government, and it must be removed. H.R. 328 is a most attractive, sound way to show that this Committee and Congress is thoughtful and resolute in seeking proper solutions to our nation's economic problems.

We appreciate your request that we testify on this most important matter. On behalf of savers and investors, and their vital interests in the fiscal soundness of our government, we thank you for your serious interest. As always, action is what counts.

SUMMARY OF THE INDIVIDUAL INVESTMENT ACCOUNT ACT
H.R. 328

- Unlimited tax deductions for all contributions from any taxpayer.
- Tax-free investment growth until withdrawal.
- All withdrawals are taxed at ordinary income tax rates.
- No penalty tax on any withdrawal.
- No forced distribution at any age.
- With all withdrawals being taxed at ordinary income tax rates, there is no rational need for income tax nor estate tax at death. Beneficiary can maintain the account and assumes the benefactor's tax basis, if any.
- Principal Residence Rollovers:

  Home Purchase: Up to $15,000—indexed for inflation—of otherwise taxable distributions may be rolled over from the account without tax for first purchase of principal residence. However, the tax basis of residence is reduced by like amount.

  Home Sale: Proceeds from sale of a principal residence may be rolled over into the investment account without tax. The tax basis of the account is thereupon adjusted to reflect the tax basis of former residence, plus the existing law's $125,000 exemption on the home's sale after age 55.

  This home sale rollover provision is particularly attractive to "empty nesters" who won't sell their home due to the income tax on the gain that mainly arises from inflation. This provision lets them roll over an unproductive asset (home) for productive investments in the account. Thus, they may be able to live better in retirement. The government will probably make money on this, because otherwise the "empty nester" may opt for a "stepped-up basis" for his home upon death. This rollover provision is a valuable option for many people.

- Tax-deductible premiums for life insurance are an acceptable investment within the account, provided the proceeds are payable into the account for investment therein and eventual taxable distribution.

Mr. THOMAS. Thank you, Mr. Kelly; thank you very much for your testimony.

I thank the panel for its testimony. Does any member of the majority wish to inquire?

Mr. Houghton.

Mr. HOUGHTON. Thank you very much, gentlemen, for being here. Obviously, this is an issue of great concern. I wonder if any of the other witnesses agree with Mr. Kelly.

The reason I ask this question, we were talking about this the other day, and it seems to me, we have got a condition in this country which works against savings. Everything that the credit card companies espouse works against savings, and everything that stores espouse works against savings, and business doesn't save at all. Business either pays out dividends to stockholders or it puts money in investment. Poor people have a very difficult time with saving. So it comes in sort of a very narrow strip of those people who are saving the way we consider saving.

Now, in Japan, the saving rate is between 10 and 15 percent of the GDP. And if we have a GDP of $6.8 trillion—call it $7 trillion—in order to get to 10 percent, that would be $700 billion. I don't see anything which doubles from 4-point-whatever-it-is to 10 that would be needed to borrow from ourselves rather than borrow from the outside to take care of our trade deficit. I don't see anything in these programs other than H.R. 328 that gets us anywhere close to the amount of dollars that we need, which is roughly $350 billion in new savings.

Maybe you would like to comment on that.

Mr. JAFFE. I would agree with you, but I think we need to take the focus off the marginal players, the people on the low and high ends. Whatever we do, it is not going to change their lifestyle or spending or consumption habits.

However, there is a large group in the middle. And one of the problems is that consumption has an immediate payback and you see what you bought and you can use it and touch it and things like that, whereas you sort of can't see that with savings. But if you put in enough carrots up front, you definitely can change the mood and the motivation of the public.

Our clients continually want to know what they should do from an aftertax point of view. And taxes are the tail, not the dog, but it is a big tail. And you need to—an unlimited IRA deduction will change the saving habits of that middle group, absolutely.

Mr. HOUGHTON. I think it probably will, but the question is, does it generate the money which we need as a Nation, that we keep talking about?

Mr. SNYDER. I think we have seen a major reduction in the amount of savings from roughly 5.6 percent of GDP in 1981 to 1985 to 3.4 percent today, a 40-percent reduction in 10 years. And we are saving half as much as Germany is; only 25 percent as much as the Japanese. So there is no question there has been a drastic change.

If one looks at dates, one sees the changes occurring in synchronism with the recession, the job uncertainty, and uncertainty for the future value of the dollar.

It would seem to me that anything that would be an added incentive to personal saving would be worthwhile and would put more money into the savings system. Whether or not this particular bill or any other bill would make a substantial difference, I am not in the position to determine at this time. In general, our organization would be in favor of anything that does promote savings for a long term, particularly for retirement.

Mr. HOUGHTON. Would you like to comment on that, Mr. Kelly?

Mr. KELLY. First of all, in all the discussion here today—I have sat through most of it—we have always talked about how we need to increase the incentives for saving. My position is that we don't need to increase the incentives for saving; we need to decrease and get rid of the disincentives for saving.

When you have an unlimited tax deduction for saving, you return to neutrality on the question of saving versus consumption, and therefore the important thing is to get rid of that disincentive to saving. And when you have the disincentive to saving, you find that even in the higher tax brackets the huge disincentive to saving not only kills the taxpayer at the higher tax brackets—the higher you go the more disincentive there is—but at the same time the government is killing its own tax base. As you take away savings from individuals because of taxes, you are not going to have that money to tax again or again or again.

And what you have with tax-deferred saving is that this capital can grow in the free enterprise sector and then, when you decide to spend it and take the money out, Uncle Sam can stand there with his hand out, at the progressive income tax rates, and take away that 50 percent, or the 15 percent, depending on the individual's tax bracket. There will certainly be far more saving with unlimited tax-deductible IRAs. There is no question about that.

Mr. HOUGHTON. Could I just follow up very, very briefly.

I understand what you are saying, and I don't disagree with any of these things, but the point is we have a savings problem in this country and we are trying to wrap our arms around the basic concept of this thing; and my question is, does this do enough toward regenerating the savings psychology which we have had in this country, which has left us?

You can have success in H.R. 328. You can have success in some of the IRAs, but does it really do the thing that makes you feel that we are back on the track?

Mr. KELLY. Oh, indeed. First of all, you have to understand that with existing IRAs, we talk about the young people who don't save enough—what they don't take into account is that we have penalty taxes under individual tax-deductible IRAs, or even other IRAs, backloaded IRAs as they have them today—not backloaded, but nondeductibles. A young person who puts his money in and pulls it out before 59½, that is another 10 percentage points. That is a 67-percent tax increase. That is stupid.

What our Nation needs is the encouragement to save, go back to tax neutrality, have tax deduction for saving.

You heard the testimony here today by all the financial services industry that would say, we will go out and we will beat the bushes to bring people in to save. There is no question that savings would go up like a rocket if you permit tax-deductible saving without penalty taxes and without forced distributions and those kind of disincentives.

Mr. HOUGHTON. I have overstayed my time. Thank you, Mr. Chairman.

Mr. THOMAS. Does any member of the minority wish to inquire? Mr. Neal, cosponsor of H.R. 682.

Mr. NEAL. Thank you, Mr. Thomas.

Mr. Snyder, I have filed two versions of IRA legislation. Mr. Thomas and I have filed an expansive IRA, and I have filed a narrower version because in the end my goal is to get something passed.

Let me raise this question to you, and it cuts to the heart of the matter: If we are really trying to promote our savings rate, why do we—and I raise this as a rhetorical question, obviously—why do we argue that we ought to make it easy to get at what we put in the IRA?

Mr. SNYDER. Part of the answer depends on what age you are. For young people to save money on the future when they do not know what will happen in their future is asking quite a bit. In addition, when they are young it is hard to save for retirement because they are saving for a home or trying to make ends meet with a minimal salary and young children. If you place more restrictions on the IRA, what you are doing is making it more difficult for a younger person to make the commitment.

For those of us who are my age or older, the restrictions don't matter much. My kids are all out of college and earning their own livings and doing quite well. It is the middle group that suffers when you tighten the restrictions.

By easing the restrictions a little bit, you add a reason to invest in an IRA. So I personally would be in favor of minimal restrictions, and I would personally be in favor of the provisions we have been talking about here.

My organization is in favor of an expanded, tax-deductible IRA. The need is greater now than ever before, because of the mobility of our profession.

Mr. NEAL. Mr. Kelly, and then Mr. Jaffe, if you want.

Mr. KELLY. If your question is, do we need restrictions on the person so that he will not pull it out, let me just make this observation. I have already commented about penalty taxes, but when you put money into an IRA with a tax deduction, you are going to pay tax at ordinary income tax rates when you pull it out. And that is enough disincentive to pull it out right there.

But if the person wants it, let him take it out. The important thing is to get them to save in the first place, and having people contribute moneys as best they can as they go through life will do wonders for the savings in our Nation. I heard Alan Greenspan testify and say that's what our Nation needs, is just save for a rainy day.

Mr. NEAL. At lower interest rates.

Mr. KELLY. That will lower interest rates. That is right. You heard the same testimony. When you have more savings, you are going to have lower interest rates. When you have more computers, they are going to drop in price; it is no different.

Mr. NEAL. I see you have given some thought to this.

Mr. KELLY. I have been at this for a long time.

Mr. JAFFE. If you assume that the average individual works 40 years and we could get that individual to contribute $2,000 in each of his first 7 years, he will have just as much money for retirement as that individual who doesn't contribute for the first 7 years and contributes $2,000 for the next 33 years.

The sooner you save, the easier it is. And while we would rather you didn't take the money out, having that impediment to take the money out results in it not getting in. So we are in favor of easier ways to letting the money out. And my suggestion is that the public will fall in love with having that big savings account and that money will stay there.

Mr. THOMAS. Thank you very much.

I want to thank the panel.

Mr. Kelly, you are stroking all of my biases with your testimony because people talk about a flat tax and the consumption tax and a whole new way of approaching taxes. I think under our current system if you would free up the distinction between savings, and spending—which is—consumption—and savings, and not have a tax disincentive to save, you would go a long way in changing the current tax system to create an opportunity for investment.

But I have a very particular question to Mr. Jaffe whose profession is advising people about what they ought to do with their finances.

When we changed the rules on the IRA, both in terms of the deductibility but also limiting who can get it, in terms of your panoply of planning approaches, did you have a hole there? Was the IRA an important part of your presentation, or was it not around long enough to create an opportunity to mix with other structures? Did it create a hole or was it just not there?

Mr. JAFFE. It was always one of the first things that we could look at, even today, because there are many people who do still qualify for the tax-deductible IRA. It would be the first suggestion that we would look at to find tax-efficient ways to improve the person's meeting of its objectives.

To say there is a hole, sure, if that is no longer available as a tax-deductible vehicle and there are other vehicles that can do the job better today, then we would go down the pecking order to what makes the most sense for a particular situation.

Mr. THOMAS. But at the time that it was available, the IRA was one of the more attractive first offers in terms of financial planning?

Mr. JAFFE. We have 2,000 clients, and I cannot think of one who has compensation that did not have an IRA.

Mr. KELLY. A comment was made that, yes, we have to get something passed. I think it was Mr. Neal that made that observation.

May I observe to the committee that this committee and the taxwriting committee and the budget committees are those who are charged with the responsibility of getting our tax system right. And if this committee and the taxwriting committee and the budget committee cannot get the scoring right, then our Nation is in deep, deep trouble.

May I urge you to think about that.

Mr. THOMAS. On that note, today's hearing is adjourned. Tomorrow morning at 10 o'clock; the Ways and Means hearing on the Contract With America will continue in this room at 10 a.m. tomorrow. Thank you.

[Whereupon, at 1:52 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, February 1, 1995.]

TAX PROVISIONS IN THE CONTRACT WITH AMERICA

WEDNESDAY, FEBRUARY 1, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. The committee will come to order. If our guests and members of the committee will please take seats so we can commence.

Today is the final day of our full committee hearings on our Contract With America. We have, over the last month, heard from innumerable people, a cross section of experts, some from the real world, some from the academic world, and they have given us a lot of input.

I believe we have a much better understanding of the provisions as we proceed to the markup phase. Our panel of witnesses today represents the Bar Association, accounting and pension professions. The committee has always valued the technical comments of these organizations.

We also will hear from witnesses about the home office deduction provision in the Contract. This provision, which overturns an unfortunate interpretation by the Supreme Court, will provide welcome relief to small businesspeople across the country.

We are also going to hear from witnesses about the estate tax exemption increase contained in the Contract, and today's witnesses probably all will agree that our work in the estate tax area has only just begun. The estate tax is arguably the most unfair tax we have on the books, taking as much as 55 percent of the value of family businesses and farms merely because someone has died.

In addition, the estate tax is a direct dollar-for-dollar tax on capital savings which we so desperately need in this country for job creation.

Finally, we will discuss the debt reduction checkoff contained in the Contract. This provision will allow taxpayers to participate directly in reducing the national debt and presents some interesting possibilities.

But before moving to our witnesses, I recognize Mr. Kleczka for the opening statement on the minority side.

Mr. KLECZKA. Fine. Thank you, Mr. Chairman.

Mr. Chairman and members, today I would like to address that part of the Contract which provides for the deficit reduction checkoff box. Under this proposal, taxpayers would have the option of checking a box on their income tax return designating up to 10 percent of the amount of tax they owe to be directed toward deficit reduction. While it sounds like a simple and commonsense proposal, it is far from it.

The checkoff box is, at best, a gimmick and at worst a straitjacket that will cause unforeseen harm to Americans. In order to understand why this idea offers no benefits and risks a great deal of harm, let me first explain how it works.

Under the bill, individuals could check off a box on their income tax return and designate that up to 10 percent of their tax liability would go toward deficit reduction. Treasury would then be required to provide Congress with an estimate of the total amount of funds designated by taxpayers to go toward deficit reduction for the prior year. After the current fiscal year appropriations bills have all been passed, Congress then would have the responsibility of going back and enacting further spending cuts. And if we chose not to or were unable to do so, we would face across-the-board reductions in all programs.

That is where the harm comes in. Spending cuts under this Contract are already going to be severe. A number of proposals already before the committee will cost billions of dollars.

For example, according to Treasury, the capital gains tax preference will cost $183 billion over the next 10 years. Neutral cost recovery will cost $120 billion. The super IRAs will cost $17 billion, and the $500-per-child tax credit will cost an estimated $288 billion. In fact, the total cost of the tax provisions alone exceeds some $725 billion. That is nearly three-quarters of a trillion dollars.

My Republican colleagues have assured me all proposals in the Contract will be paid for with spending cuts. Cutting three-quarters of a trillion dollars in the budget means that about every American stands to lose something. All programs will have to be cut and cut deeply.

Everyone likes to say cut fraud and abuse in the system. Unfortunately, my friends, there is not three-quarters of a trillion dollars of abuse going on. That means people should expect cuts in programs like Medicare, veterans benefits, education and student loans and just about every other program you can think of.

Now, if you add this checkoff proposal, the cost of the Contract grows even larger. In 1994, individual income tax receipts amounted to $542 billion. That means if everyone took advantage of the box and checked off the full 10 percent every year for the next 10 years, we would have to cut an additional $54 billion—or a total of $542 billion—in addition to the $725 billion already called for. That does not even take into consideration the balanced budget amendment, which will lead to even more cuts.

How is Congress going to cut all this spending to the bone and then have to come back and cut even further?

Worse still, there will not be a warning as to the size of these additional cuts. Americans will have to wait until all the numbers are computed by Treasury to learn if the programs they depend on are at risk of being cut once again. In fact, we Democrats have consistently asked for a list of what programs will be cut to pay for the Contract and have yet to get a satisfactory answer.

The checkoff proposal means that even if Republicans did answer us, and the American people also received the answer on what they intend to cut, that list would not be complete. Further cuts would be needed to pay for the amount that the individuals checked off. As a result, the checkoff box will tighten the straitjacket on government even further. It could prevent Congress from assisting victims of natural disasters, could deny Congress the ability to provide for its most vulnerable citizens, the elderly, and it will stop Congress from helping those veterans who have fought for this country.

It is a very serious problem, and it deserves very serious consideration. In America, we believe in one person, one vote. However, the checkoff box gives the wealthy more say than other groups in government. Since the wealthy owe a greater amount of tax, if they check off the box, the amount that must be cut from spending will be greater. In this way, the wealthy can force Congress to cut more. That is unfair and that is wrong. The wealthy do not deserve a greater say in government than the middle class or the poor.

Finally, if my Republican colleagues believe the checkoff box is such a good idea, let us ask the taxpayers to give us more advice as to where to cut. I propose another set of boxes alongside the 10 percent checkoff box, and those set of boxes would have broad Federal spending categories like defense, social programs, welfare, agriculture, education, and veterans programs.

Any taxpayer who checks the 10 percent deficit reduction box will then be asked to give us further guidance as to where we should cut those programs. They could choose one or they could choose more. Know full well there are those in our society who will check the 10 percent checkoff box and also check defense. Well, that will not sit too kindly with some Members of this Congress. And there are those who will come back and check off the 10 percent deficit reduction box and go after welfare, and that will not sit well with others. But I think if we are going to budget by initiative referendum, my friends, let us go all the way. Under this method, Americans can make all the tough decisions that we in Congress are forced to make every day. They can determine the spending allocations that appeal to them.

Obviously, such a proposal would be unworkable and would not make sense, no more sense than the original Contract proposal on the 10 percent deficit box.

I want to work with my Republican colleagues on this Contract. Some of the proposals are genuinely good, and I am happy to be here to discuss them with you. I like the IRA proposals and am interested in the capital gains indexing proposal. However, I cannot support misguided proposals like the checkoff box, and I am disappointed such an idea would be put forward. Hopefully, we will all have the wisdom to delete it and get down to the work on the serious proposals before the committee.

Chairman ARCHER. Without objection, as usual, every member will have the right to insert any statement in the record at this point.

[The following was subsequently received:]

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA
February 1, 1995

Mr. Chairman, it is a pleasure to welcome this panels -- particularly since two of the witnesses are from Minnesota: John Forsythe and Tom Diedrich.

Mr. Forsythe is Vice President for Tax and Public Affairs of Ecolab, St. Paul, MN, and is testifying on behalf of Ecolab's Sales Force Employees.

Mr. Diedrich of the Diedrich Group, Minnetonka, MN, is here on behalf of the Bureau of Wholesale Representatives.

I am very pleased we have two witnesses from Minnesota who know how much this tax relief will help the self-employed and other workers who conduct their business at home.

Clarifying the home office deduction would make a major difference to thousands of small businesses in the Third Congressional District and throughout Minnesota and the country. The home office deduction provision is one of several initiatives in the Contract with America that recognizes the important contribution small businesses make in our economy. Small businesses create over 80 percent of the new jobs in America.

The home office deduction provision is on the cutting-edge of job trends as more Americans choose to "tele-commute" by computer or utilize other methods to work at home. We should especially help parents with young children who want to spend more of their working hours at home.

The Contract With America's Job Creation and Wage Enhancement Act includes a provision allowing taxpayers to qualify for the home-office deduction if the home-office is (1) used exclusively for business purposes, (2) used on a regular basis, (3) used to perform tasks that could not easily be performed elsewhere and (4) is essential to the taxpayer's business.

Mr. Chairman, thank you again for assembling such an excellent panel. I look forward to hearing from all of our witnesses today.

Chairman ARCHER. Our first two witnesses will be Congressman Wayne Allard from Colorado and Congressman Bill Barrett from Nebraska.

We are happy to have you here with us this morning, and I am sure you are aware of the standard we try to live by here which is to keep your oral testimony within 5 minutes and submit your entire written statements for the record. Without objection, you will have that right. We are again pleased to have you.

Congressman Allard, you may proceed.

STATEMENT OF HON. WAYNE ALLARD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. ALLARD. Thank you, Mr. Chairman and members of the Ways and Means Committee. Thank you for allowing me to testify today before the committee on a topic which is very near and dear to my heart and that is the home office tax deduction.

I would also like to recognize the hard work that another member of your committee has put forward on this issue and that is Congresswoman Johnson from Connecticut. And I look forward to working with her on this very important issue and the rest of the committee.

As you know, the recent *Soliman* Supreme Court decision and subsequent IRS regulations have made it impossible for many business entrepreneurs to use the home office tax deduction. This situation must be remedied.

In the last Congress I introduced legislation which was cosponsored by 79 colleagues. This Congress I have introduced H.R. 40, which in just the first 4 weeks of this session has been cosponsored by 65 of our colleagues. This legislation is designed to restore Congress' original intent, which I believe was to make the home office tax deduction available to a wide array of small businessowners and entrepreneurs.

With April 15 fast approaching, the last thing most Americans want to think about is taxes. In fact, the average American must now work the first 125 days of the year to pay all Federal, State and local taxes.

The bulk of the family tax bill consists of income taxes, payroll taxes and property taxes. However, one factor which adds to the growing tax bill of many self-employed and small businessowners are the new rules governing the home office tax deduction.

Increasingly, it is the little guy who gets squeezed by the tax system. While large corporations can rent space and deduct office and virtually all other expenses, many taxpayers who work out of their homes are no longer able to deduct their office expenses.

Traditionally, the Tax Code has permitted individuals who operate businesses within their homes to deduct a portion of the expenses related to that home. However, over the past 20 years, Congress, the courts, and the IRS have reduced the scope and usefulness of the deduction.

The most serious blow came 2 years ago with the Supreme Court decision and subsequent IRS action virtually eliminating the home office deduction for many.

Under the Supreme Court's new interpretation of principal place of business, a taxpayer who maintains a home office but also performs important business-related work outside the home is not likely to pass IRS scrutiny. This change effectively denies the deduction to taxpayers who work out of their home but also spend time on the road. Those impacted include sales representatives, caterers, teachers, computer repairers, doctors, veterinarians, house painters, consultants, personal trainers and many more. Even though these taxpayers may have no office other than their home, the work they perform will often deny them a deduction.

According to the IRS, 1.6 million taxpayers claimed a home office deduction in 1991. While not all of these taxpayers will be affected by the change, many will. Clearly, any taxpayers who operate a business out of their home must review their tax situation.

There are many reasons why a broad home office tax deduction is important. The deduction is profamily. It helps taxpayers pursue careers that enable them to spend more time with their children. The deduction helps cut down on commuting and saves energy. The deduction recognizes the advances of technology—computer and telecommunication advances mean that more and more individuals will be able to work for themselves and maintain a home office.

The deduction is a boost to women and minorities who are increasingly starting their own businesses. In fact, over 32 percent of all proprietorships are now owned by women entrepreneurs, and Commerce Department data reveals 55 percent of these women businessowners operate their firms from home.

Minorities are making similar advances. There are now well over 1 million minority-owned small businesses, and a good number of these are operated out of the home.

I think it is critical that we pass this legislation, and I ask that the Ways and Means Committee give it very serious consideration. Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony
Rep. Wayne Allard
Home Office Tax Deduction
Committee on Ways and Means
February 1, 1995

Mr. Chairman, Members of the Ways and Means Committee, thank you for allowing me to testify today before the Committee on a topic which is near and dear to my heart -- the Home Office Tax Deduction.

As you know, the recent Soliman Supreme Court decision and subsequent IRS regulations have made it impossible for many small business entrepreneurs to use the home office tax deduction. This situation must be remedied.

In the last Congress I introduced legislation which was cosponsored by 79 colleagues. This Congress I have introduced H.R. 40, which in just the first four weeks of this session has been cosponsored by 65 of our colleagues. This legislation is designed to restore Congress' original intent, which I believe was to make the Home Office Tax Deduction available to a wide array of small business owners and entrepreneurs.

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The bulk of the family tax bill consists of income taxes, payroll taxes, and property taxes. However, one factor which adds to the growing tax bill of many self-employed and small business owners are the new rules governing the home office tax deduction.

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Traditionally, the tax code has permitted individuals who operate businesses within their homes to deduct a portion of the expenses related to that home. However, over the past 20 years Congress, the courts, and the IRS have reduced the scope and usefulness of the deduction.

The most serious blow came two years ago when a Supreme Court decision and subsequent IRS action eliminated the home office deduction for many. Under the Supreme Court's new interpretation of "principal place of business" a taxpayer who maintains a home office, but also performs important business related work outside the home is not likely to pass IRS scrutiny.

This change effectively denies the deduction to taxpayers who work out of their home but also spend time on the road. Those impacted include sales representatives, caterers, teachers, computer repairers, doctors, veterinarians, house painters, consultants, personal trainers and many more. Even though these taxpayers may have no office other than their home, the work they perform will often deny them a deduction.

According to the IRS, 1.6 million taxpayers claimed a home-office tax deduction in 1991. While not all of these taxpayers will be affected by the change, many will. Clearly, any taxpayers who operate a business out of their home must review their tax situation.

There are many reasons why a broad home office tax deduction is important. The deduction is pro-family. It helps taxpayers pursue careers that enable them to spend more time with their children. The deduction helps cut down on commuting and saves energy. The deduction recognizes the advances of technology -- computer and telecommunication advances mean that more and more individuals will be able to work for themselves and maintain a home office.

The deduction is a boost to women and minorities who are increasingly starting their own businesses. In fact, over 32 percent of all proprietorships are now owned by women entrepreneurs, and Commerce Department data reveals that 55 percent of these women business owners operate their firms from home. Minorities are making similar advances. There are now well over one million minority owned small businesses and a good number of these are operated out of the home.

Finally, the home office tax deduction helps our economy. It benefits small businesses and entrepreneurs who develop new ideas, and create jobs. Many of America's most important businesses originated out of a home office.

Small business is increasingly the engine which drives our economy. With large firms downsizing, entrepreneurs must pick up the slack. The importance of this trend is demonstrated by the job shift that occurred during the slow recovery from the most recent recession. During the period of October 1991 to September 1992 large businesses cut 400,000 jobs while small business created 178,000 new jobs. During the boom years of the 1980s, the vast majority of the 20 million new jobs created were in the small business sector.

It is critical that recent assaults on the home office tax deduction be reversed. That is why I have introduced legislation to fully restore the deduction. I am pleased to note that similar language is included in the Contract with America. It is therefore guaranteed a vote in the House in the first 100 days.

This invariably leads to the question, How is your bill different from the language in the Contract With America?

First of all, I think we all achieve the same objective, I think any Congressional action is going to send a clear message to the IRS and the courts that we intend for the deduction to apply more widely.

Having said that, I feel our version contains elements that are missing from some of the others. We make clear that if the home is the sole fixed location of the business, then the deduction can certainly be taken. We also tie the IRS' hand and prevent them from using some of the arbitrary numerical tests that have been used to restrict the deduction in the past.

The goal is to make clear that if one uses a portion of the home exclusively and regularly for a home office, then one can generally take the deduction.

I plan to be very active in working to see that restoration of the home office tax deduction is approved by both the House and Senate, and signed by the President in 1995. Thank you. I will be happy to take questions.

Chairman ARCHER. Thank you, Mr. Allard.

Our next witness is Congressman Bill Barrett. Congressman Barrett, you may proceed.

STATEMENT OF HON. BILL BARRETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. BARRETT. Mr. Chairman and members of the committee, thank you so much for having this hearing in the first place and allowing me to speak in favor of increasing the estate tax exemption from $600,000 to $750,000, and then, of course, indexing it thereafter.

Although I strongly support the provision in H.R. 9, the Job Creation and Wage Enhancement Act, I need to add that I believe the exemption does not go far enough. It will not fully address the problems the Tax Code creates for keeping family farms in the family.

The American Farm Bureau and other agricultural organizations believe the estate and gift tax exemption should be increased to levels of up to $2 million. They argue that more farms have assets exceeding the $600,000 exemption, and the heirs are forced to sell inherited property to pay estate taxes.

Due to inflation, and, of course, the nature of farmers to hold on to their land—an average of 28 years now per farm—owners of farms are more likely to be affected by the estate tax than other people. The average value of farm assets for the 55,000 farmers in Nebraska is now $697,000 per farm.

Some opponents of raising the exemption level believe the so-called wealthy estates have enough liquidity that it is not a problem to pay estate taxes, and, of course, the other expenses attendant to inheritance. Unfortunately, these opponents do not have an understanding of family farm operations nor do they understand how capital-intensive family farms really are and must be—to remain viable.

Farmers may appear wealthy on paper, but, in reality, most of the overwhelming number of farmers have very little cash on hand, with the bulk of their estates or their assets tied to farm real estate and equipment. In Nebraska, farm real estate accounts for more than 70 percent of the total assets for an average farmer.

The heirs of these estates are usually the sons or the married daughters that are actively involved with the farming operation but have very few assets themselves. The heirs may be assisting with the actual farming, but the properties are solely owned by the decedent. Due to the exemption allowed under current law, the family heirs are too often forced to sell a portion of the farm real estate to pay taxes, which, in turn, threatens the viability of the restructured farm operation. The disposed property is not just an asset but it is an important income-producing asset.

Another concern, Mr. Chairman, as it relates to the estate tax question, is the average age of our Nation's farmers. Compared to the average head of households in the United States today, which is 48 years of age, roughly half of the 2 million farmers in this country today are age 55 or older. More than 17 percent of our farmers are now 70 years of age or older. This creates a situation where there will be an extensive turnover of farming operations in the next few years as we lose these older farmers. If Congress does not raise the estate tax exemption, we will lose farmers, and we will be losing the foundation of family farming upon which American agriculture has thrived.

Opponents may also argue family farms may utilize a provision of the Tax Code for special use valuation of farm real estate. Earlier, when I referred to H.R. 9 not going far enough, I was making reference to this issue, specifically section 2032A, the provisions on the special use provision.

This special use valuation applies so long as the inheriting family members continue to farm the property. If an inheriting family member chooses to cash lease their interest to the family member to actually farm the property, section 2032A does not apply. A daughter who, as a doctor, may return to the community and cash rents to her brother does not qualify.

I believe disqualifying property from special use valuation solely on the basis of a cash leasing arrangement among family members is contrary to the congressional intent which is behind section 2032A. The bill I introduced, H.R. 501, clarifies that a cash leasing arrangement among inheriting family members will not disqualify the property for special use valuation. It goes a step further and includes surviving siblings and other qualifying heirs.

Mr. Chairman, the provisions of H.R. 9 will go a long way to help keep the family farm in the family, and later in this session I hope that we can discuss further changes to the estate taxes to help keep the family farms in the family.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of the Honorable Bill Barrett (NE-3
House Ways and Means Committee
February 1, 1995

Thank you, Mr. Chairman, for having this hearing and allowing me the opportunity to speak in support of increasing the estate tax exemption form $600,000 to $750,000 by 1998, and to index it for inflation thereafter.

Although I strongly support this provision in HR 9, the Job Creation and Wage Enhancement Act, I must add that I believe the exemption does not go far enough, and won't fully address problems the tax code creates for keeping family farms in the family.

As you know, the American Farm Bureau and other agricultural organizations believe the estate and gift tax exemption should be increased to levels up to $2 million.

They argue, correctly, that more and more farms have assets exceeding the $600,000 exemption, and the heirs are forced to sell land, equipment and/or buildings to pay estate taxes.

Due to inflation, and the nature of farmers to hold on to their land--an average of 28 years per farm--owners of farms are more likely to be affected by the estate tax than the general population.

The average value of farm assets for the 55,000 Nebraska farmers is $697,000 per farm.

Some opponents of rasing the exemption level, or heaven forbid, those who would even lower the $600,000 level, believe these so-called wealthy estates have enough liquidity that it is not a problem to pay estate taxes and other expenses.

Unfortunately, these opponents do not have a general understanding of family farm operations, nor do they understand how capital intensive family farms must be to remain viable.

Farmers may appear wealthy on paper. However, in reality the overwhelming number of farmers have very little cash-on-hand, with the bulk of their assets tied to farm real estate and equipment.

In Nebraska, farm real estate accounts for more than 70 percent of the total assets for an average farmer.

The heirs of these estates are usually the sons or married daughters that are actively involved with the farming operation but have few assets themselves.

While the heirs may be assisting with the actual farming, the machinery, land and buildings are solely owned by the decedent.

Due to the exemption allowed under current law, the family heirs are too often forced to sell a portion of the farm real estate to pay taxes which in turn threatens the viability of the restructured farm operation.

As you know, the disposed property is not just an asset, but it is an important income producing asset.

Another concern, as it relates to the estate tax question, is the average age of our nations' farmers

Compared to the average head of households in the US, which are 48 years of age, roughly half of the 2 million farmers are age 55 or older. More than 17 percent of our farmers are 70 years of age or older.

This creates a situation where there will be an extensive turnover in farming operations in the next few years as we lose these older farmers.

If Congress does not act to raise the estate tax exemption, we'll not only be losing farmers, we'll be losing the foundation of family farming upon which American agriculture has thrived.

Another point opponents may argue is that family farms may utilize a provision of the tax code for special use valuation of farm real estate, and therefore need no further relief from estate taxes.

When I refer to HR 9 not going far enough to give family farms tax relief, I was making reference to this issue, specifically Section 2032A.

I have introduced legislation, HR 501, to amend the Internal Revenue Code (IRC) Section 2032A, the special use provision.

In 1976, Congress sought to help families keep their farms by allowing a farm to be valued in its use as a farm, rather than at its market value.

This "special use" valuation applies so long as the inheriting family members continue to farm the property.

But suppose one of the inheriting heirs does not choose a life on the farm. Perhaps, for example, it is a young doctor who has returned to practice in her rural hometown, but she won't be farming. She'll leave that up to her brother.

If this inheriting family member chooses to cash lease her interest to the family member to actually farm the property, Section 2032A does not apply.

I believe to disqualify property from special use valuation solely on the basis of a cash leasing arrangement among family members is contrary to the congressional intent behind Section 2032A.

My bill, HR 501, clarifies that a cash leasing arrangement among inheriting family members will not disqualify the property for special use valuation.

Mr. Chairman, I understand that the Committee is strictly focusing today on provisions in HR 9 that raise the estate tax exemption, and may not be ready, or willing, to also include extraneous measures, such as HR 501.

While I can certainly respect the Committee's position, I hope that at some future point we can discuss further changes to estate taxes toward the goal of keeping family farms in the family.

Believe me, the relief provided by HR 9 for family farms will be beneficial and will go a long way toward keeping alive the family farm. But I encourage the Committee to finish the job by considering and passing provisions from HR 501.

I appreciate being given this opportunity and stand ready to answer any questions you may have.

♦ ♦ ♦ ♦

Chairman ARCHER. Gentlemen, thank you for your very cogent input to the committee. Do any members wish to inquire?

OK, I have Mr. Bunning, Ms. Dunn and Mr. Kleczka. Anyone else? Mr. Herger. All right.

Mr. Bunning.

Mr. BUNNING. Well, rather than inquire, I want to thank both Mr. Barrett and Mr. Allard for their testimony and agree with Mr. Barrett on our ability to expand that deduction past the $750,000 limit. Because of personal experience with it, and with experiences in my district with that restriction being at $600,000, we need to expand the deduction now; particularly in the farm community, which 14 of my counties that I represent are so involved with family farms, and with the inflated value of those family farms as far as tax liability is concerned.

The home office deduction—I am a cosponsor with Wayne Allard on that bill, and have been in the last Congress, and could not agree with him more that that ought to be looked at and included, and I just hope that we can get it done.

Thank you both for your testimony.

Mr. ALLARD. Thanks for your comments.

Mr. BARRETT. Thank you.

Chairman ARCHER. Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

I have a question for Representative Allard. Under your proposal for the home office deduction, my question is what is built into the legislation to prevent abuse of restoration of this deduction and also what are the limits on the actual deduction?

As I look at your testimony, you indicate one category of professionals would be teachers, another would be doctors. I can see a teacher bringing home some homework or tests to grade, things of that nature. Would that qualify for a home office deduction? Or in the doctor situation, does that home office have to be used for examining patients, seeing patients or just he claims he does work there?

I am saying if that be the case, I have an office in my home also where I take back constituent correspondence, call constituents, work on legislation, and I am wondering if I would also qualify?

Mr. ALLARD. No, sir, you would not qualify because that is not your sole fixed location of doing business. The purpose of the——

Mr. KLECZKA. Well, the teacher's sole fixed is not his or her home either.

Mr. ALLARD. The purpose of the legislation is to try to reduce the regulatory burden on the home office person, the person who is trying to work out of his home. Frequently, that is where businesses start. That is where people get started in business. If we are going to open that up, we need to do that.

So I want you to look very closely—it is the sole fixed business location language that we add, and you have to use your home exclusively and regularly as a home office.

Let me give you one example of somebody who—or a couple of people in your community, I am sure, that you can find who work out of their homes. Probably an electrician or——

Mr. KLECZKA. Give me a teacher example, where a teacher would qualify.

Mr. ALLARD. I don't see a teacher qualifying unless they are running a day care center—you are thinking about the regular professional teacher?

Mr. KLECZKA. Right. Goes home from school, from the classroom.

Mr. ALLARD. In terms of a day care teacher or a teacher providing for the handicapped and doing that teaching out of their home, then, obviously, if they have a room set up and they are teaching to handicapped children or young people, then it is part of their business as a contract teacher and they would qualify.

Mr. KLECZKA. The activities would have to happen in the home itself.

Are there any limits on the actual deduction that could be claimed?

Mr. ALLARD. There is no maximum deduction on there, except that I think just because of the homes that you are dealing with, I do not think that is going to be particularly a problem.

Basically, what we are talking about, the figure I give you, we are talking about people who are starting out in business in their home. If they are a large business, then the incentive is there for them to move out and to rent space and to incur the cost of operating, basically, a business out of their home. Because it is much more convenient, you have so many employees, and most people do not want to do business——

Mr. KLECZKA. OK, I understand that, but my further question on the actual deduction. If I have five rooms to my home, and I devote one for the home office, I can deduct from my taxes one-fifth of all the expenses of the home, from mortgage to heat to light and everything else?

Mr. ALLARD. Not necessarily. If that room is the least expensive room, as far as operating—maybe you built five rooms on. Maybe the other four are extremely expensive rooms, and that one you are running your home office is a less expensive room. It has to meet the qualification that it is used as the regular place of business, as a sole and fixed location, and that is where you are running your business out of.

Mr. KLECZKA. Who makes the determination as to how much I can deduct?

Mr. ALLARD. Well, obviously——

Mr. KLECZKA. Let's say it is the most expensive room in the house.

Mr. ALLARD. As any businessman will know, if you are a prudent businessman you need to itemize all your costs and get a portion down as a percentage of your total cost of doing business. So you allocate that particular amount of cost related to that room and then that becomes the cost of doing business as far as that room is concerned.

Mr. KLECZKA. So in a five-room example, I can deduct one-fifth of the cost of everything associated with the home, including the cutting of the grass.

Mr. ALLARD. No, in my view, that depends on the cost of that room. You could take a deduction—if it is the least expensive of the rooms, then you would take a proportionate share of the total cost for that room. You do not necessarily take 20 percent.

Mr. KLECZKA. I can see some real abuse coming here, and I do not think we have enough IRS auditors to go and measure homes and find the value of homes. Thank you.

Chairman ARCHER. Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman.

I want to commend our two witnesses, our colleagues, for your long-time work on behalf of American agriculture and the family farmer.

I particularly want to commend you, Mr. Barrett, and your testimony, in bringing out the fact of our family farms and the difficulty in being able to keep our family farms farming, being able to pass on from one generation to the other those who have created the best-fed nation in the history of the world that we have, with a smaller amount of farmers every year.

And particularly you speak about some legislation you have that has to do with the Revenue Code section 2032A, the special use provision. I might just add to that, that number has not been changed since 1983. Certainly, it is time for a change. I commend you and support your legislation. Congressman Thomas and I have legislation in this same area. Again, I thank you for your work.

Mr. BARRETT. Thank you, Mr. Herger.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman, and thank you very much, gentlemen, for testifying. I think you have hit some sensitive nerves here, and I certainly support you both in what you are trying to do.

Mr. Barrett, I wanted to add to your excellent description of how the estate tax currently affects farmers by telling you that in my district we have a number of small timberowners of timber farms, and the effect on that group is that their family, upon death, cut the trees and sell the property. So, eventually, because of this terribly onerous burden of regulation, we are losing small timber farms in the State of Washington, and it is a great tragedy because that affects the ability of the public to come onto private property where the owners have allowed them to use the facilities for recreational use and a number of other uses.

So I agree with you the law must be changed, and your proposal is a most interesting one. We have heard others, but I think yours gets closer to reality when it comes to the amount of exemption that we should allow.

Mr. BARRETT. There are some real-life stories out there—thank you, Ms. Dunn—about the adverse effects, social, economic, political effects, on the populace. I think this is an area which needs to be addressed. Thank you.

Chairman ARCHER. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman. I want to thank my colleagues, Mr. Allard and Mr. Barrett, for testifying today.

The estate tax exemption and the home office deduction are critical issues to me and to the people of the Fourth District of Michigan, and I want you both to know I appreciate your efforts in this regard and in making these items more workable for the taxpayers of this country. Thank you.

Mr. ALLARD. Thank you.

Mr. BARRETT. Thank you.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. I also want to thank the witnesses. And, Congressman Barrett, as my entire family lives and farms in your district, I can't tell you how much this kind of relief is needed.

The old saying that a farmer lives poor and dies rich could not be further from the truth. Not only today do they live poor but they die poor because of this type of low exemption. We need to correct it. I support it, and thank you for your testimony today.

Mr. BARRETT. Thank you.

Chairman ARCHER. Gentlemen, thank you very, very much.

Mr. BARRETT. Thank you, Mr. Chairman.

Mr. ALLARD. Thank you, Mr. Chairman.

Chairman ARCHER. Our next panel: Mr. Porter, Ms. Walker, Mr. Terry, Deborah Walker, and David Walker. Please take your seats at the witness table.

Before introduction of our first witness, I would like to recognize my colleague, Nancy Johnson of Connecticut.

Mrs. JOHNSON. Thank you, Mr. Chairman.

It is a special pleasure to welcome Michael Porter to this hearing. He is the C. Rowland Christensen Professor of Business Administration at Harvard University and has conducted extensive research on the competitive strategies of companies and on the competitiveness of states and nations.

He serves as cochairman of the Subcouncil on Capital Allocation of the Competitiveness Policy Council, charged with developing concrete recommendations for improving the savings rate and efficiency of corporate investment in America. He has also led major research on efforts to deal with the problems of underinvestment and economic development in America's inner cities.

I welcome you here today and the rest of the panelists.

Mr. PORTER. Thank you.

Chairman ARCHER. Mr. Porter, again, the standard under which we operate is we ask you to keep your oral testimony to under 5 minutes, and you may submit a complete written statement for the record in its entirety without objection. That also applies to the rest of the witnesses.

Mr. Porter, you may proceed.

STATEMENT OF MICHAEL E. PORTER, C. ROWLAND CHRISTENSEN PROFESSOR, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Mr. PORTER. Thank you, Mr. Chairman.

From someone who has spent many years studying the problems of investment in the United States, I cannot tell you how important and timely these hearings are. The central problem facing the American economy—and there is no doubt about it—is inadequate savings and especially inadequate investment by the private sector. We are simply not investing enough to support economic growth and a rising standard of living. This is true in the economy as a whole, and it is particularly true in our distressed inner-city areas, where investment is leaving rather than coming.

The only way we are going to be able to sustain a rising standard of living in this country is to step up the rate of investment, especially in equity capital. It is equity capital that supports entry into new products and new services, that supports the R&D that is required to create new jobs rather than just boost the productivity of existing businesses, which often reduces employment.

Yet the rate of investment by American industry is declining at a precipitous rate. In fact, as of 1993 or 1994, the net investment, after depreciation, of American industry is now only 2 percent of GDP rather than 3.5 to 4 percent in the seventies and sixties. It is no wonder that even the somewhat slow economic rate of growth that we have now forces us into capacity constraints because our net rate of investment in the economy is so low.

Why do we have low investment in our corporate sector? Well, there are three basic causes that you have the means to deal with in this committee.

The first is, of course, inadequate savings, not just savings by government in the form of dissavings but low private savings that have fallen from 6 percent of GDP as recently as the early eighties, to 3 percent of GDP in 1994.

I share with you the view that we must reinstitute some kind of an individual retirement account incentive for savings. I believe, however, that our retirement account proposal should be related to income; that is, you should have to save more, depending on your income, to get the benefit. The details are in my testimony.

The second fundamental cause of underinvestment in our economy in the corporate sector is overinvestment in real estate. The United States spends an enormous fraction of its overall pool of investment capital in real estate. Indeed, as you all probably know, in a single year, the total tax break for investment in residential real estate in the United States is $82 billion per year to incent investment in this particular form which, although it does create jobs and it does improve our quality of life, does not have the same leverage in improving the long-term growth of the economy as investment in the corporate sector.

I believe it is time to scale back some of the subsidies for real estate investment, particularly for affluent Americans. The details are in my testimony.

The third problem, limiting corporate investment, is not just a savings problem, but it is a deeper problem having to do with the way we regulate the financial markets in this country and the way we create tax incentives that work against investment.

We have this low rate of investment in U.S. industry in new plant, equipment and R&D, yet we have companies buying back tens of billions of dollars of their stock instead of investing.

Last year's stock buybacks totaled about $70 billion. That did not create new assets—that was not net investment by corporations. That was them buying back their own stock.

We have a continued high rate of M&A activity in this country. Instead of new investment in new plant and equipment, companies last year spent $230 billion making acquisitions that changed control of assets but did not create new net assets.

Now, why is this happening? Well, first of all, it is happening because of outmoded and excessive regulation of our financial markets that dates back to the twenties and thirties when our financial markets were different, when the owners of equity shares in America were small individuals. We simply must reform our financial market regulation.

I am chairing a group that will issue a report on this in the spring.

But of particular interest to this committee is the disincentive that our tax system places on investment, particularly investment in equity capital. Our system is biased against equity investment—severely biased against equity investment. It double taxes dividends on equity. It double taxes retained earnings on equity capital. By not indexing capital gains, it biases against long-term equity investment toward short-term holdings.

The 1986 Tax Reform Act was supposed to equalize the treatments of various forms of income. Instead, it increased the bias against equity investment which we so desperately need.

I share with this committee the sense that we must introduce a long-term capital gains incentive. However, as detailed in my testimony, I believe it should be limited to equity investment. I think this is where the greatest leverage for economic growth comes, and I also believe it should be prospective. I think we should not give windfalls for past investments. We should make the incentive prospective on new investments with the clock starting today.

I share with you the view that we must index capital gains for inflation, and I would also move toward starting to provide an exclusion for dividend income from equity. The details are in my statement.

We have a particularly acute problem of lack of investment in the Nation's inner cities. Our past approaches to dealing with distressed communities have failed. I detail those in some of my writings on this subject, which I will provide to the committee.

[The writings are being retained in the committee files.]

Mr. PORTER. We need a new paradigm for dealing with the Nation's inner cities, and I think that paradigm must be one that moves away from massive subsidies and uneconomic behavior and toward private sector investment in profitmaking businesses. That is the only way to have a sustained, profitable, and ongoing inner-city economy.

We must build on the competitive advantages of investment in inner-city areas. Advantages like physical proximity to the downtown business districts. Advantages like a large unmet demand in the local community.

In order to create and step up the incentives for such investments, I believe we should take those general tax policy recommendations I made 1 minute ago, but we should move more aggressively to provide incentives for investments in inner-city areas. In particular, I would propose a 100-percent exclusion of long-term capital gains from equity investment in distressed inner-city communities.

The criteria must be the location of the business and the kind of employment in that business. We should not be giving tax incentives to businesses that do not employ local residents.

I would also recommend we provide a 100-percent exclusion of dividends from equity investment in distressed inner-city communities. Many inner-city businesses do not qualify for going public, or the traditional kinds of exit options that venture capitalists use.

I think we need to provide a way to get dividends returned back to those investors to incent these investments. Again, the details of all of this are in my testimony.

I would like to thank you for the opportunity to talk so briefly about these subjects, and I would welcome your questions.

[The prepared statement and attachments follow:]

TESTIMONY OF MICHAEL E. PORTER
HARVARD BUSINESS SCHOOL

My name is Michael E. Porter. I am the C. Roland Christensen Professor of Business Administration at the Harvard Business School where I conduct research on the competitive strategies of companies and on the competitiveness of states and nations. I serve as co-chairman of the Subcouncil on Capital Allocation of the Competitiveness Policy Council, charged with developing concrete recommendations for improving the rate and efficiency of corporate investment in the American economy. I have also led a major research effort on the special problems of investment and economic development in America's inner cities.

The hearings of this Committee could not be more timely and important. The central problem facing the American economy, and the greatest limit on improving the nation's prosperity, is inadequate savings and investment. While there are many causes, the single most important cause of America's inadequate private savings and investment is the nation's tax policies. The Committee has the opportunity to institute reforms which would not only benefit the economy as a whole, but would also significantly speed up investment in our distressed inner city areas.

I will begin by examining the reasons why wages have stagnated in the United States in the recent decade and link wage growth to private sector investment. The rate of U.S. corporate investment has stagnated and declined in the last decade. There are three main causes: inadequate savings, overinvestment in real estate, and policies limiting corporate investment. In each area, tax policy plays a prominent role, and I suggest directions for reform.

Inadequate corporate investment in the nation's inner cities is a particularly pressing item on the national agenda. I describe a new framework for economic development in our nation's distressed communities, based on private sector initiative and the principle of profit. The overall recommendations for tax reform should be taken one step further for distressed areas.

Investment and the Standard of Living

A rising standard of living in the United States depends on the ability to improve productivity in value terms, where value refers to the dollar value of output per worker. Improving productivity in volume terms, or the number of units of standard products produced per worker, benefits company efficiency but will not by itself support rising wages. At the same time, efficiency improvements in making standard products are more easily matched by international competitors or offset with lower wages. America's ability to compete depends critically on improving the value of products and services to command higher prices, not just lowering cost.

But improving the value productivity of existing products and services is not enough. Economic and job growth rely heavily on creating *new* products and entering *new* markets. This leads to new jobs and offsets the reduction in employment that often accompanies productivity growth in established products and services.

To increase the value of existing products, create new products, and enter new markets, firms must invest in *intangible assets* such as research and development, training, and start-up costs of entering new products and markets including costs of establishing brand names and distribution channels. Intangible investments must be financed with *equity capital*, because they provide no collateral and entail higher risk.

Productivity growth in the American economy has been slow in recent decades, resulting in declining real wage income. In the early 1980s, reported productivity growth began to rise significantly in manufacturing, leading many observers to celebrate the return to competitiveness of American industry. The celebration was dampened, however, because real wages continue to languish.

The answer to this apparent puzzle, as shown in **Figures 1 and 2**, lies in the distinction between value and volume productivity. Volume productivity, which is what is reported by the

Bureau of Labor Statistics, has indeed grown more rapidly in non-financial corporations as a whole, and in manufacturing, in the previous decade than before. Historically, as **Figures 1 and 2** illustrate, value and volume productivity tracked each other closely in the U.S. economy. Beginning in 1981, however, value productivity, which is what determines wages, has grown much more slowly. This is true for non-financial corporations and even more true for the manufacturing sector. The reason is that American manufacturing companies have not been able to sustain or improve prices. To say it differently, American manufacturing industry has done a good job in the 1980s and early 1990s of producing standard products more efficiently, but is failing to create higher value product varieties and entirely new products to the degree necessary to support rising wages.

Corporate Investment in the United States

The only way to improve the nation's value productivity and hence prosperity is through sustained investment by the private sector. It should not be surprising, then, that these disturbing trends in corporate productivity reflect a disturbing pattern of declining net investment (investment after depreciation) since the early 1980s. Yet as **Figure 3** shows, net non-residential fixed investment as a percentage of GDP has declined precipitously since 1981. Net non-residential fixed investment in recent years has been less than 2% of GDP. It should not be surprising, then, that economic growth rates in the 3% range raise fears about shortages of capacity. **Figure 4** shows the dramatically greater rate of corporate investment in Japan, the leading competitor to U.S. firms in international markets. These disturbing trends in overall corporate fixed investment apply equally to investment in machinery and equipment.

The United States is also lagging in R&D. At a time when R&D investment is increasingly critical given the knowledge intensity of competition, the United States has been investing at a significantly lower rate than Japan, as shown in **Figure 5**. The U.S. rate of corporate R&D investment as a percentage of GDP has been flat or slightly declining, while in Japan it has increased.

Without a higher rate of investment in new machinery, new capacity, new technology, and new products, the United States cannot enjoy sustained job growth or growth in wages and the standard of living.

Causes of Inadequate Corporate Investment

The causes of inadequate corporate investment in the United States can be divided into three broad categories.

1. Inadequate savings. Members of the Committee have heard a great deal about the problem of government dissavings. Equally serious is the problem of gross private savings, which have declined from about 6% of GDP as late as the early 1980s to about 3% of GDP in 1994 (see **Figure 6**). The Committee has heard extensive testimony about private savings, and the role of tax policy in discouraging it.

Recommendations for Tax Policy. I concur with those who propose the reinstitution of the individual retirement account (IRA) to provide an incentive for savings, until such time as the United States can move to a more consumption-based tax system. Any new IRA, however, should be designed to reflect the fact that feasible saving levels depend on income. Therefore, the minimum contribution to an IRA to begin qualifying for tax deferral *should rise with income*. A person making less than $40,000 a year, for example, should only receive tax deferral for IRA contributions in excess of, for example, $1,000. A person earning an income of $100,000 would have to contribute, for example, $5,000 in taxable contributions before additional contributions were tax deferred. A cap would limit the total amount that could be deferred each year. This would serve to focus the incentive on boosting savings instead of subsidizing savings that would take place irrespective of the incentive.

2. Overinvestment in real estate. While the United States begins with a woefully low level of savings, the problem is compounded by the fact that a huge fraction of the pool of savings is invested in real estate rather than in industry. As shown in **Figure 7**, net fixed investment in residential real estate accounts for *more than 50%* of the nation's entire private net investment budget. Investments in real estate create some jobs and improve the quality of life, but corporate investment has higher ongoing leverage for economic growth and wages.

The size of real estate investments in the United States is no accident, but the result of a huge array of incentives. Many of these are embedded in the tax system. For example, Federal tax expenditures (tax breaks) directly related to residential real estate in FY 1993 were $81.6 billion per year (note that the table listing tax expenditures was curiously omitted from the FY 1994 and FY 1995 U.S. budgets and must be restored). To put this number in some perspective, the tax expenditures due to expensing of corporate research and development in FY 1993 was less than $2 billion.

Recommendations for Tax Policy. It is time to move towards scaling back the massive subsidies for real estate investment in the United States, especially for more affluent Americans. One place to begin is to cap at $350,000 the combined principal amount of mortgage and home equity loans qualifying for interest expense deductibility, while indexing the cap to inflation. The cap could be phased in over time. Similarly, the tax-free rollover of capital gains in the sale of owner-occupied housing could be capped at a fixed level.

3. Policies limiting corporate investment. Low rates of corporate investment do not just reflect low savings and heavily subsidized competition for savings from real estate. Most corporate investment is funded by internally generated funds, not new savings. Corporate investment in the United States is not constrained by low profitability. Indeed, as shown in **Figure 8**, U.S. industry is among the most profitable of any in the world, and far more profitable than industry in Japan and Germany. This high current profitability implies a higher hurdle rate (required return) on investment than elsewhere and a shorter time horizon.

Consistent with this, American companies have spent tens of billions of dollars buying back their own stock rather than investing. As shown in **Figure 9**, U.S. stock repurchases in 1994 rose to $68.2 billion. Companies buying back stock (more than 990 in 1994) were not merely companies in declining industries but included firms such as Amgen, AMP Inc., Eaton Corp., Columbia/HCA Healthcare Corp., Hewlett-Packard, IBM, Lotus Development, and Merck who compete in rapidly growing industries and enjoy numerous investment opportunities.

In addition to stock repurchases, American industry continues its massive investment in acquisitions. As shown in **Figure 10**, the dollar volume of M&A activity has risen dramatically since 1980, reaching $227 billion in 1994. While acquisitions can be a part of a strategy to create new products and new businesses, much of the investment in acquisitions involves merely a change of ownership of established products and plants. Therefore, acquisition investments make only a modest net contribution to growth in the economy.

The low rate of corporate investment, as well as inefficiencies in the investments that are taking place, result from financial market regulation and tax policy.[1]

Financial Market Regulation. While the U.S. capital markets are efficient in the sense of low transactions costs and rapid processing of public information, the structure of equity ownership and corporate governance reduces the rate, efficiency, and time horizon of investment for established companies. (The U.S. system for funding startups provides major advantages vis-à-vis other nations. The problem arises when companies become profitable and well established.)

The U.S. markets are characterized by an extreme degree of separation between the ultimate *owners* of equity capital, the *investment managers* who choose which companies to invest it in, and the *professional managers* who actually run companies. This separation has

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[1] A detailed treatment of the U.S. capital allocation system and its consequences can be found in *Capital Choices: Changing the Way America Invests in Industry*, Council on Competitiveness and Harvard Business School, Washington, DC, 1992. The Subcouncil on Capital Allocation of the Competitiveness Policy Council will be issuing a report detailing specific recommendations to boost the rate and efficiency of investment in the spring of 1995.

widened and shifted dramatically in character with the growth of pension funds and mutual funds over the last several decades. The separation between owners, investment managers, and professional managers is exacerbated by regulation which limits the ability of owners and investment managers to become directly involved in corporate governance.

This separation means that owners, investment managers, and professional managers have widely differing amounts of information about long-run corporate prospects, but all share good information about current profitability. Separation also implies that equity owners must measure the performance of investment managers, and investment managers must do the same for professional managers (who own little stock). Such performance measurement, in the face of limited information about long-term fundamentals, inevitably shortens investment time horizons. Owners measure investment managers based on quarterly and yearly portfolio appreciation. Investment managers, in turn, are under enormous pressure to select companies based on their potential for near-term stock price appreciation, which is most heavily influenced by surprises in current earnings. The net result is pressure on companies to raise current profitability. Companies buy back their stock to prop up share prices that are sensitive to earnings-per-share growth, and are rewarded through price appreciation for taking large write-offs which will make it easier to show growth in next period earnings. Profitability is high, and funds invested by companies are deployed efficiently. Yet companies are not investing enough to sustain product prices, fuel growth, and maintain competitive position in the long run. The massive fall in the value of the dollar, as in the 1970s, has served to mask the international competitive consequences of this set of choices.

These measurement and information problems are exacerbated by the fragmentation of equity ownership, which is partly the result of government regulation. Securities regulation was designed in an era when unsophisticated individuals owned most stock, and has not been modified to reflect the fundamentally different circumstances today. The result is that investment managers own small stakes in many companies, and lack the incentive or ability to develop information about long-term prospects and to take an active role in corporate governance. Yet unlike individual investors, investment managers are motivated to engage in rapid trading based on perceived near-term stock price movements. The average holding period of a share of stock has fallen from about seven years in 1960 to about two years today. This heightens the sensitivity of professional managers to near-term earnings, deters investments with long-term payouts, and encourages acquisitions which produce instant growth in sales and profits. Note that the other nations with capital market structures similar to the United States—the United Kingdom, Canada, and other former British Empire nations—have also been chronic underinvestors in recent decades.

Redressing these problems will require relaxing outdated securities and pension fund regulations, encouraging greater long-term ownership by employees and managers, limiting unnecessary securities litigation, and other steps to be contained in the Report of the Subcouncil on Capital Allocation.

Tax Policy. Tax policy constitutes the other drag on corporate investment. The U.S. tax system, as is well known, is biased against investment except in real estate. What is less well known is that our tax system is biased heavily against equity investment, especially long term equity investment. The U.S. system imposes double taxation of dividends from equity investments while it taxes interest on debt only once. Through taxes on capital gains, it also imposes double taxation of retained earnings (earnings that are reinvested in the business). Capital gains are not indexed for inflation, which creates a bias against investments with a longer term payout and a bias against holding. The net effect of these policies is to dramatically increase the return required on equity investments in companies to produce an acceptable after-tax return to investors. The 1986 tax reform, while seeking to equalize the tax treatment of different forms of income, actually made the bias against long-term equity investment far worse.

These tax policies and the U.S. financial market regulation combine to generate rapid trading, high investment hurdle rates, large equity buybacks, heavy investment in acquisitions, and low investment in fixed assets and R&D by established companies.

Recommendations for Tax Policy. Ideally, the United States would move towards a consumption-based tax system. In the interim, however, the following changes take on critical priority to increase the rate of long-term corporate investment, especially in equity:

- Provide a 50% exclusion for long term capital gains from equity investments in corporations. In order to both reduce the double taxation of retained earnings and lengthen time horizons, the minimum holding period should be at least three years. Alternately, the percentage exclusion should rise with longer holding (e.g., 10% exclusion if held one year, 20% exclusion if held two years; up to a 50% exclusion if held 5 years). The exclusion would not apply to investment in residential real estate, collectibles, bonds, or other forms of assets. To limit the cost of this policy and to avoid windfalls, the exclusion should be prospective, with the holding clock starting with the date of enactment.

- Index capital gains for inflation, using a revised CPI reflecting actual inflation, to further reduce the bias against long-term investment.

- Provide a 50% exclusion for dividends on equity investments in operating companies, to reduce the double taxation of dividends.

Corporate Investment in Inner Cities

These recommendations will increase the overall rate and time horizon of corporate investment in the U.S. economy. However, nowhere is corporate investment more needed than in the nation's distressed inner city areas. Unless we find new approaches, the inner cities will continue to be a drain on the shrinking public coffers. Revitalizing inner cities requires the creation of healthy local economies and jobs, not just meeting social needs. Without the parallel development of jobs, efforts to address social problems cannot be successful, especially in a time of fiscal scarcity.

Past approaches to economic development in inner cities have failed. Real estate development projects, based on the false premise that real estate development would attract industry, have proven disappointing. Huge subsidies to entice firms to locate in inner city areas have not led to sustainable companies and have further drained public funds. My paper *The Competitive Advantage of the Inner City* describes the problems with these and other past approaches, which share a common flaw—they defy economic reality.

Economic reality is this: sustainable economic development in inner cities, or anywhere else, can only result from profitable, private sector investments which do not need ongoing direct subsidies. Profitable investment, in turn, must rest on the competitive advantages of an inner city location compared to elsewhere in the regional economy. The inner city can only produce profitable firms if it can find an economically viable niche based on trade and exchange in the region.

My research suggests four types of potential competitive advantages of an inner city location. These must become the cornerstone of an inner city economic development strategy:

- *physical location*: proximity to downtown business districts, transportation and tourist infrastructure, hospital complexes, and other attractions.

- *local demand*: the ability to serve a large, underserved market in the inner city with distinctive needs.

- *integration with competitive clusters in the regional economy*: the employment and commercial opportunities (buying and selling) arising from the ability to link with centers of excellence in the region.

- *availability of certain types of human resources:* access to a large labor pool of loyal employees suitable for a range of industries and occupations.

The businesses which currently survive and even prosper in inner city areas are those that benefit from these advantages, despite facing numerous obstacles such as security, infrastructure, and regulation. With a concerted strategy, their potential is far greater.

The central goal of government policy toward inner city economic development must be to *enhance the economic value of the inner city as a profitable business location.* In the spirit of federalism, state and municipal governments must identify the competitive advantages and disadvantages of each particular city, and customize a strategy to their particular circumstances. The disadvantages of inner cities today as a place to do business must be eliminated, via programs in training, security, infrastructure, deregulation and the like that reflect an economic strategy rather than structured as social programs. Subsidies will be necessary, but must be directed to improving sites and upgrading business infrastructure rather than propping up firms without true profitability.

The only way to achieve sustainable economic development in inner cities is to mobilize the capital and expertise of the private sector. **Figure 11** summarizes the differences between this approach to economic development in inner cities and the old models that have failed.

<u>Recommendations for Tax Policy</u>. Tax policy has an important role to play in aligning incentives with the goal of sustainable economic development in troubled cities. In particular, tax incentives *based on the premise of profit* can play a vital role in speeding up private investment in inner city areas as part of a broader strategy to improve the inner city as a business location. The same tax biases against equity investment that exist in the economy at large must be eliminated in inner cities, but we need to move more aggressively given the social and economic distress of these communities.

Tax incentives should be based on company or subsidiary location in distressed areas and employment of local residents, *not* the race and gender of business owners. Race- and gender-based programs are subject to manipulation and may fail to benefit inner city residents. Distressed inner city areas can be defined as census tracts where 50% of the households live below 80% of the median income of the surrounding metropolitan area and unemployment is 25% greater than the state average.

Specific tax policy changes should include the following:

- Provide 100% exclusion of long-term capital gains from equity investment in companies or subsidiaries located in distressed inner city areas, provided these firms provide a minimum level of employment of local residents.

    - require a minimum 3-year holding period or exclusion increasing with holding period
    - require a minimum percentage of workforce from the local community (for example, 25%)
    - a business would be defined as a single-unit company or a profit center based in the inner city

- Provide 100% exclusion of corporate dividends from inner city-based companies or subsidiaries with a minimum level of local employment. Many of the businesses that can prosper in inner cities will not be amenable to public offerings and other traditional exit strategies. Fully tax exempt dividends will create a powerful way to provide ongoing return to investors without the need for sale or recapitalization.

    - set rules to ensure that dividends are paid from profits after reasonable compensation and subject to normal transfer pricing rules, to avoid abuses.

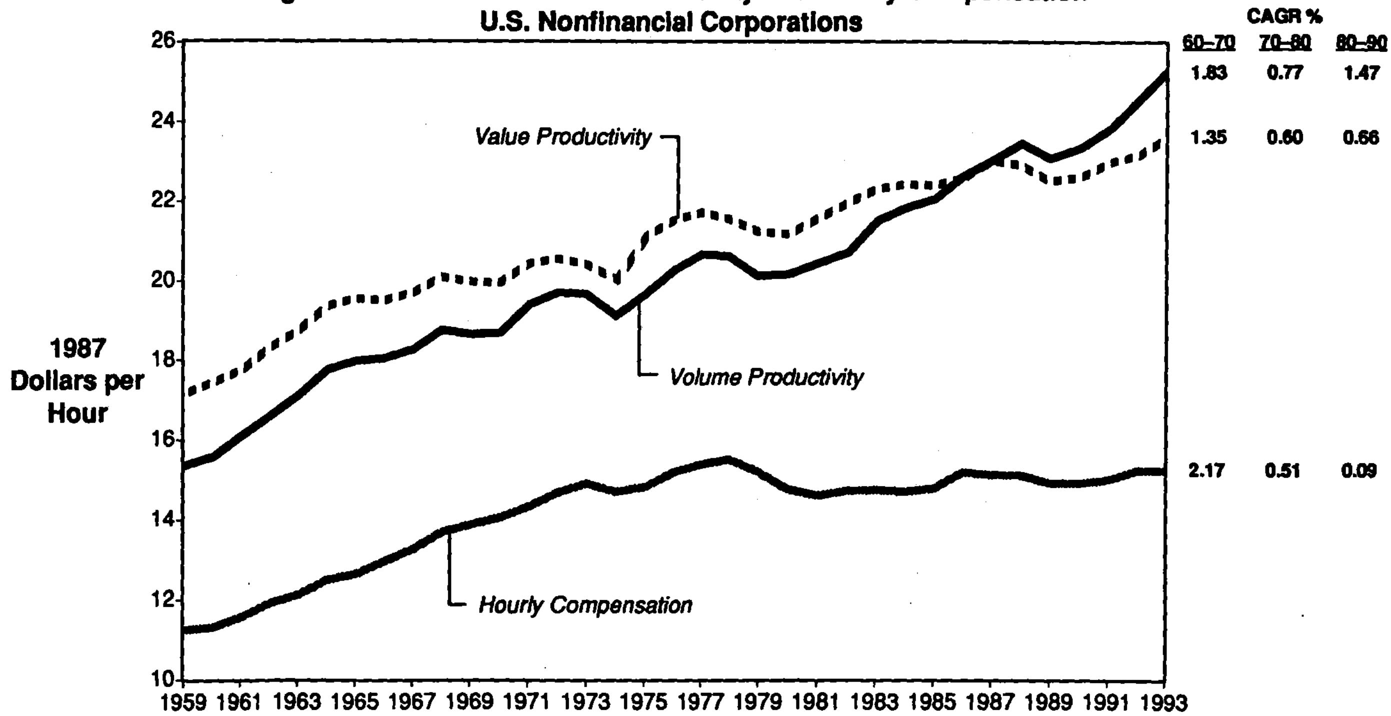
Implementation and oversight of these benefits will be based on the same general principles that govern the tax code generally.

- Use of this incentive will be on a self-certifying basis, subject to audit in the regular IRS cycle. Once qualifying census tracts are defined, businesses would be required to certify that a minimum of 25% of their employees were local residents.

- On audit, businesses would have to prove that dividends paid were from profits, and the recipient of the dividend would have to have received written notification from the company that they were eligible for the exclusion. For publicly traded companies meeting these requirements, the financial institution executing the trade would have to notify the purchaser of eligibility.

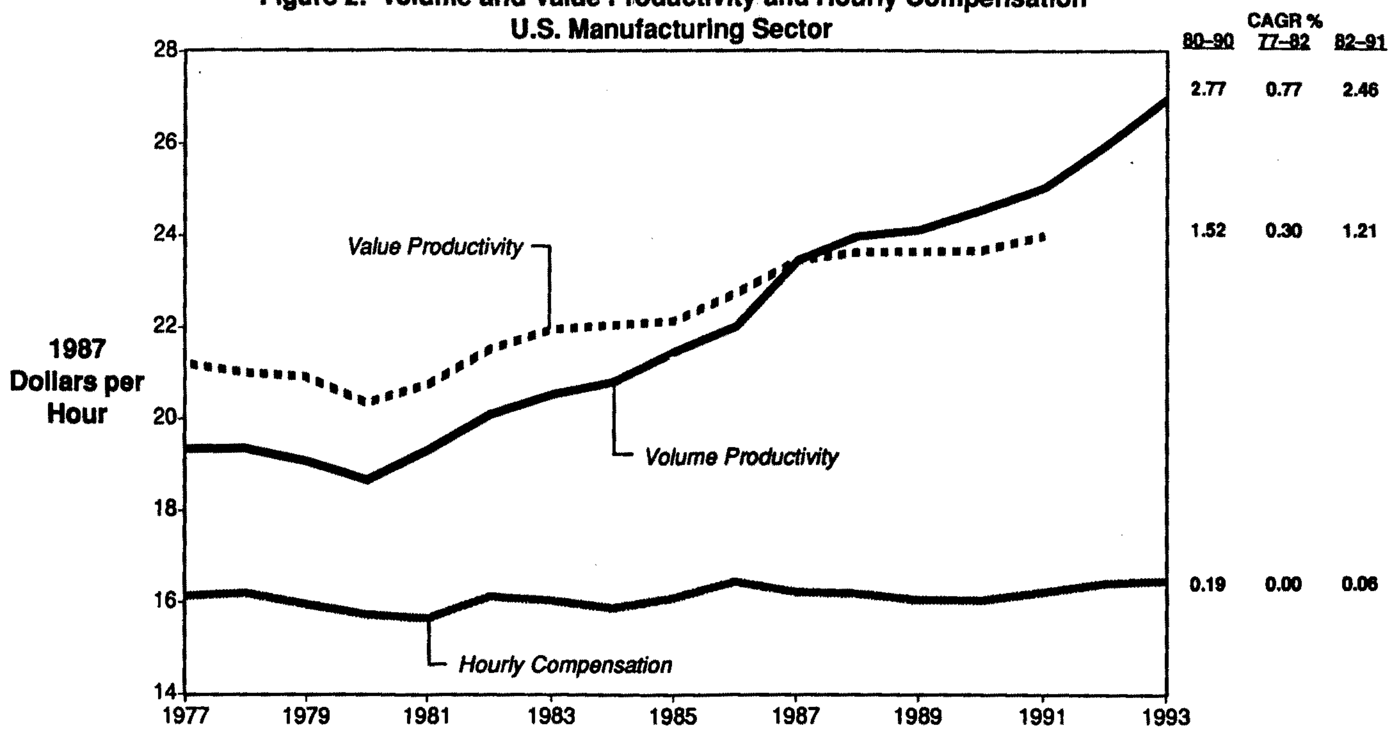
The Committee's commitment to encourage investment through tax reform provides a historic opportunity to develop an urban policy that seeks to restore the economic vitality of our cities by grounding development policy in sound economic theory. From the experience gained from real estate tax policies, we know it can work. Each of these policy changes sends a very clear message that Congress believes in the competitive advantage of the inner city and is willing to invest in creating a sustainable economic base.

Figure 1: Volume and Value Productivity and Hourly Compensation
U.S. Nonfinancial Corporations



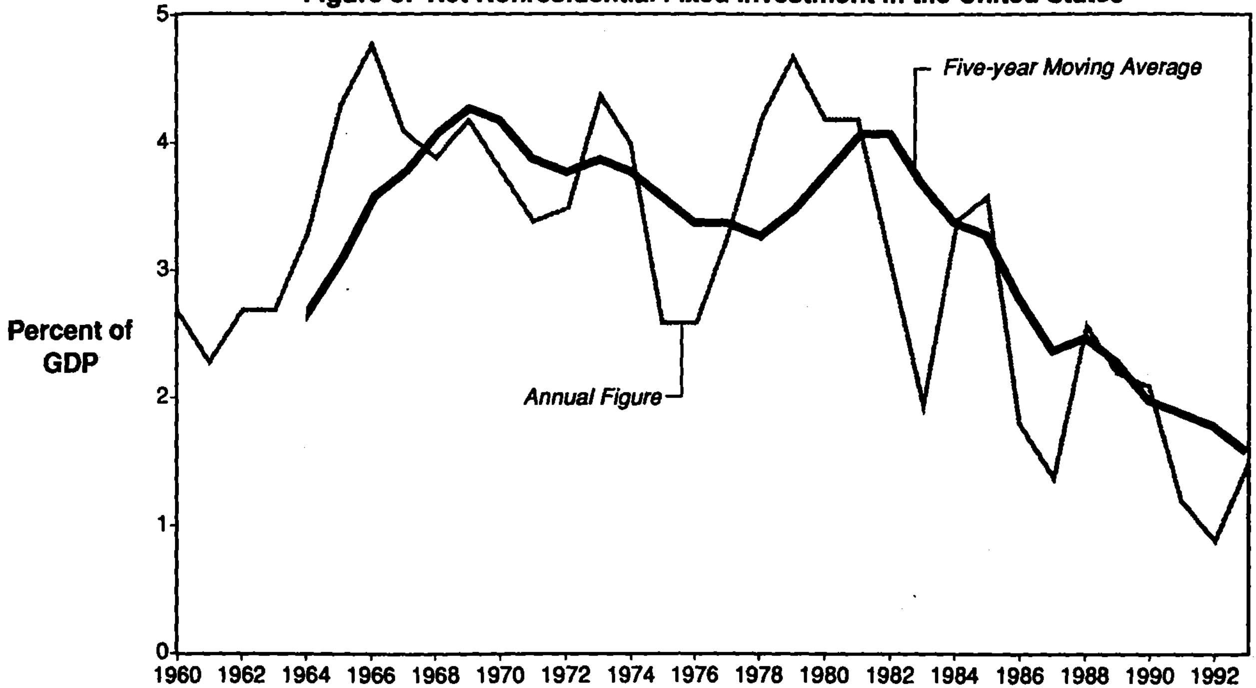
Source: Bureau of Labor Statistics, Author's Calculations

Figure 2: Volume and Value Productivity and Hourly Compensation
U.S. Manufacturing Sector



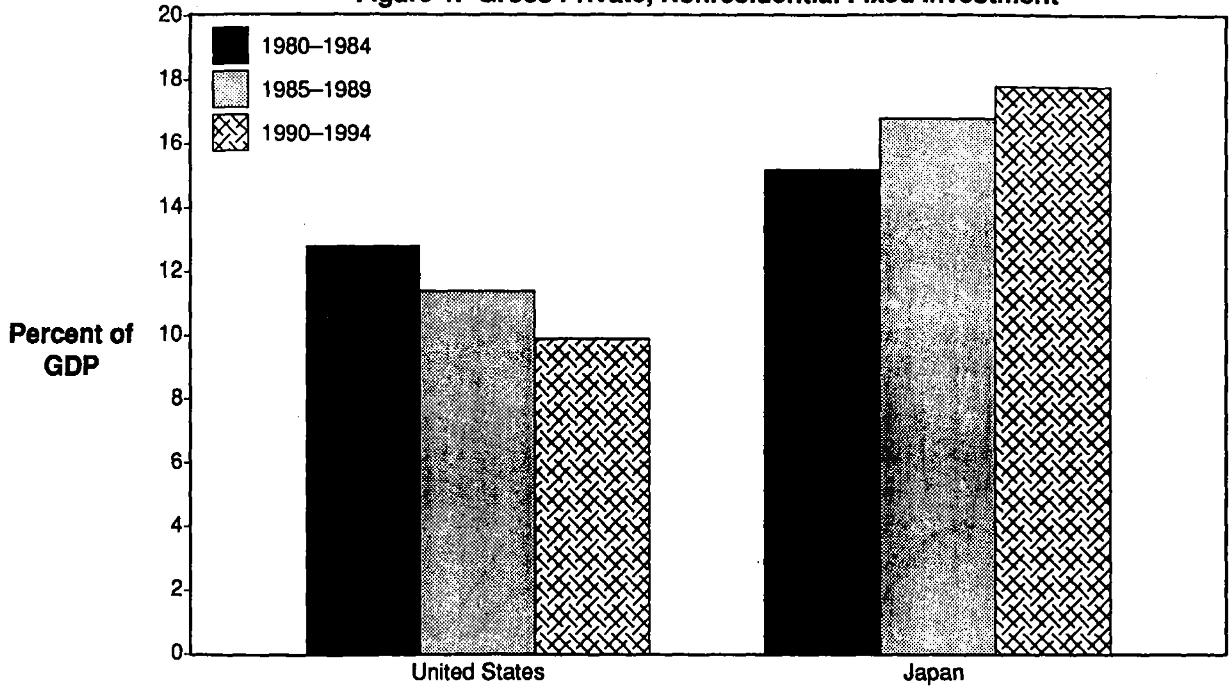
Source: Bureau of Labor Statistics, Author's Calculations

Figure 3: Net Nonresidential Fixed Investment in the United States



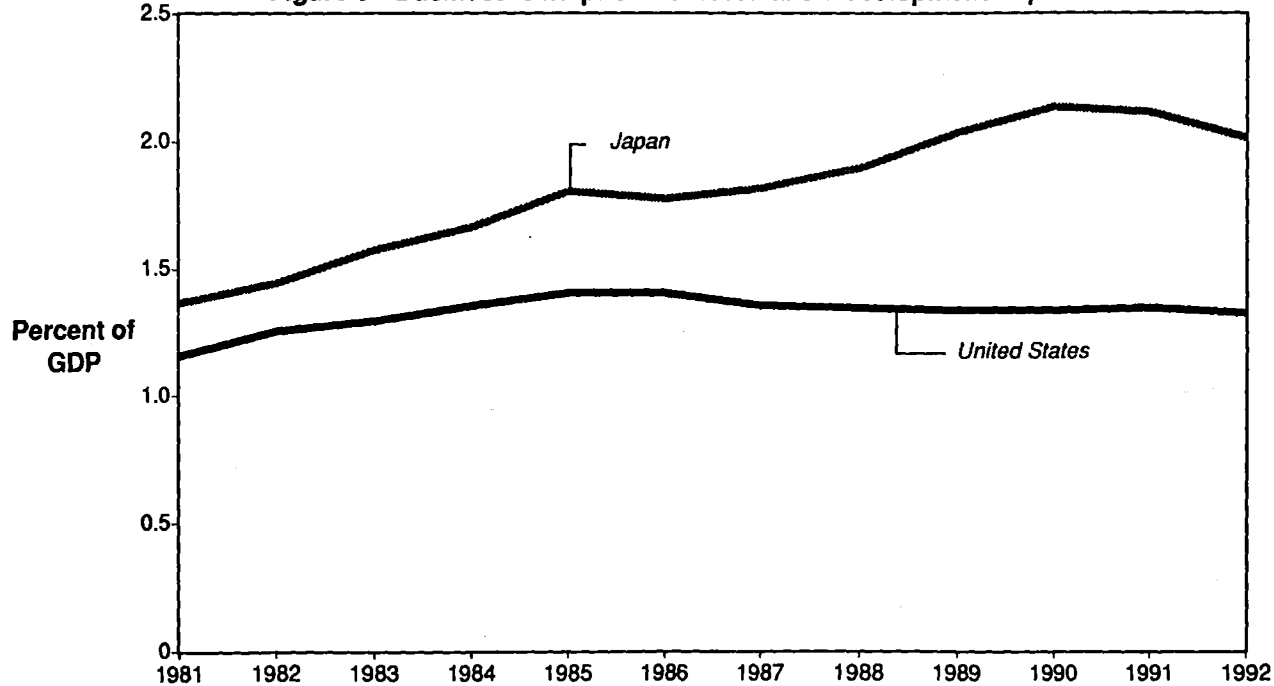
Source: *National Income and Product Accounts, Survey of Current Business*

Figure 4: Gross Private, Nonresidential Fixed Investment



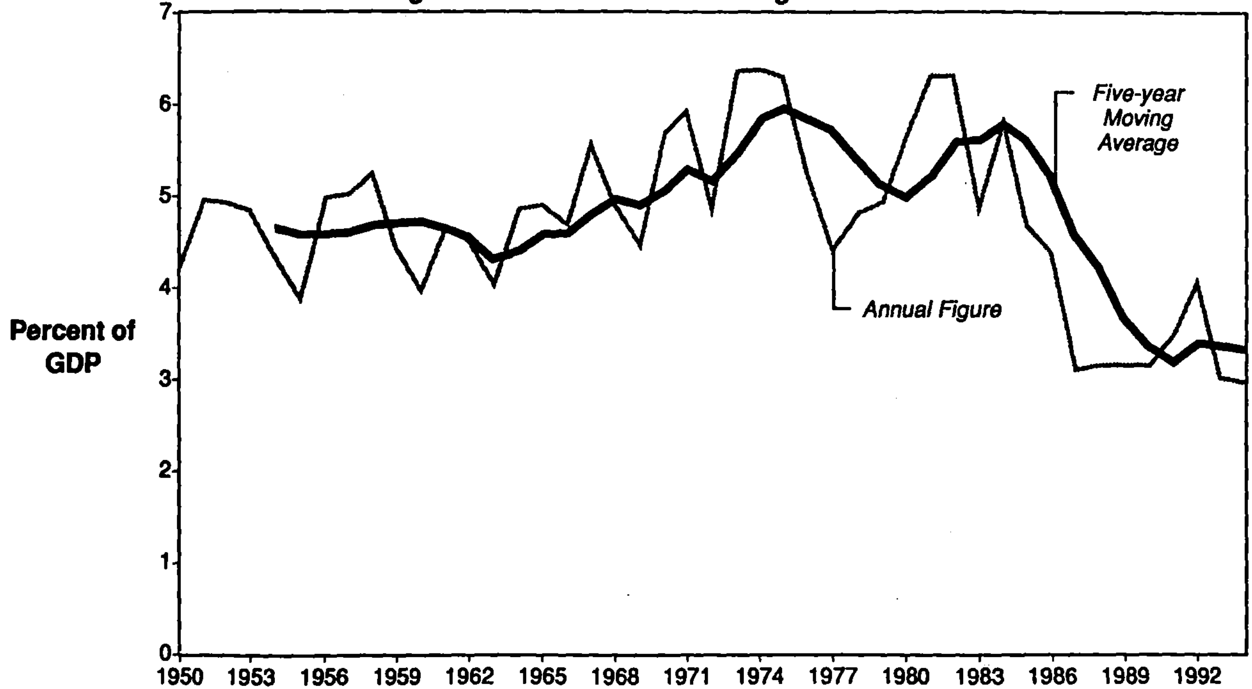
Note: 1994 based on first two or three quarters
Source: OECD Quarterly National Accounts

Figure 5: Business Enterprise Research and Development Expenditures



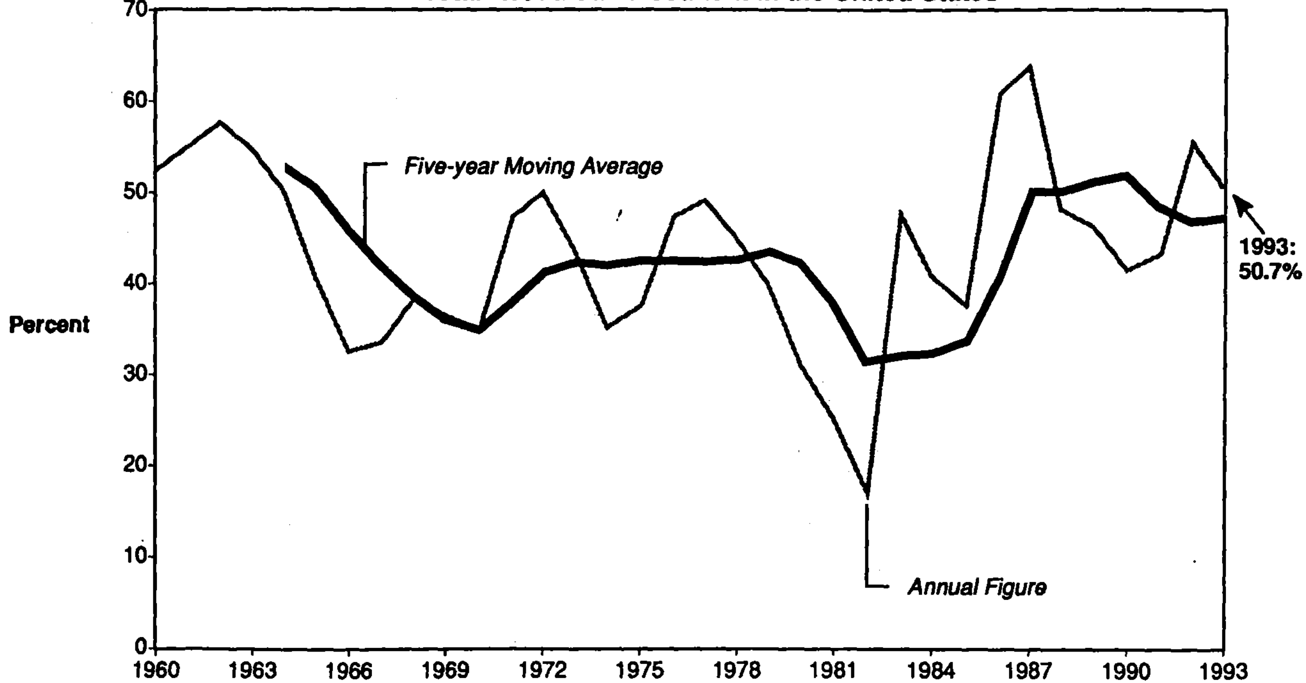
Note: Exclusive of government support. Figures are estimated or adjusted, as necessary, by OECD Secretariat. U.S. data excludes all or most capital expenditures. Japanese figures based on overestimated data.
Source: OECD / EAS (STIU Database), May 1994

Figure 6: Gross Personal Saving in the United States



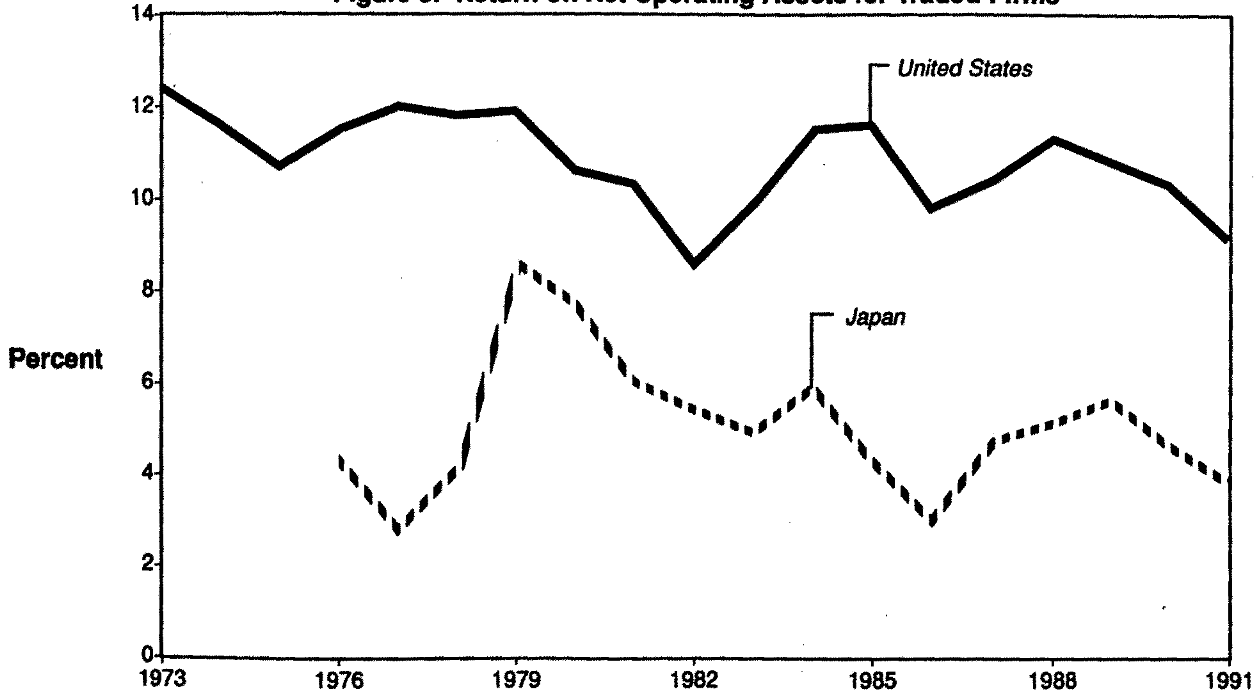
Note: 1994 data based on first three quarters
Source: *Survey of Current Business*, U.S. Department of Commerce

Figure 7: Net Residential Fixed Investment as a Portion of Total Net Fixed Investment in the United States



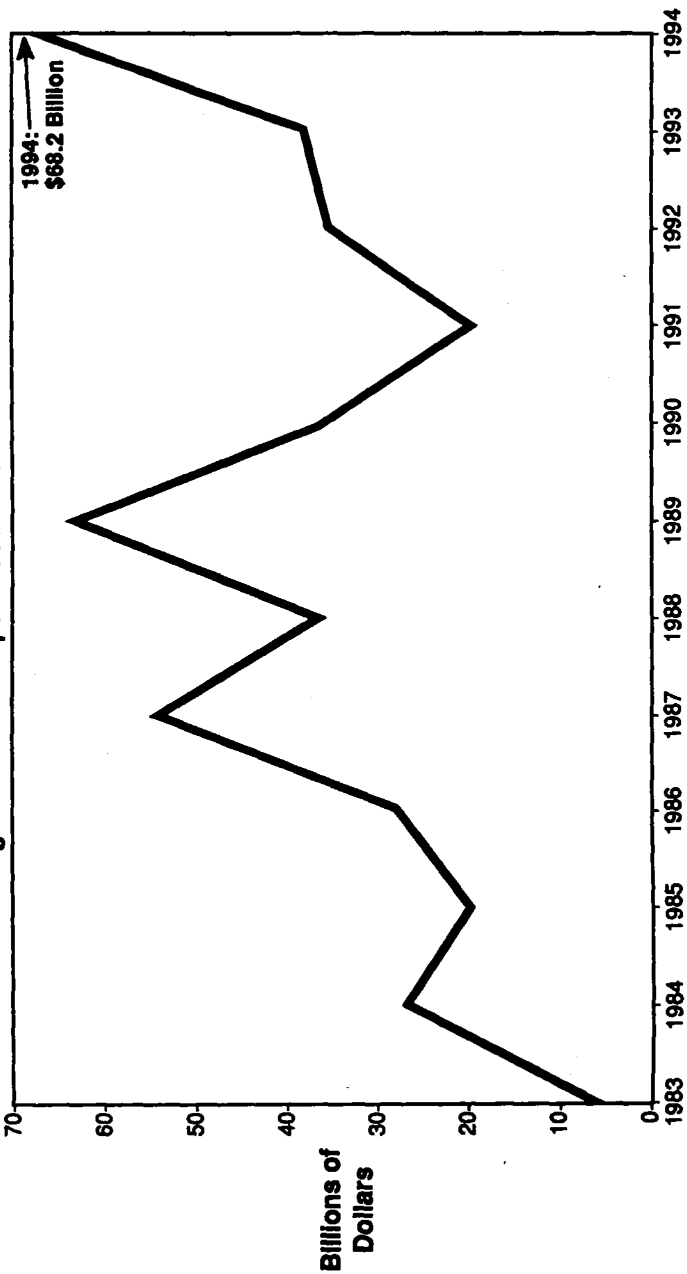
Source: *National Income and Product Accounts, Survey of Current Business*

Figure 8: Return on Net Operating Assets for Traded Firms



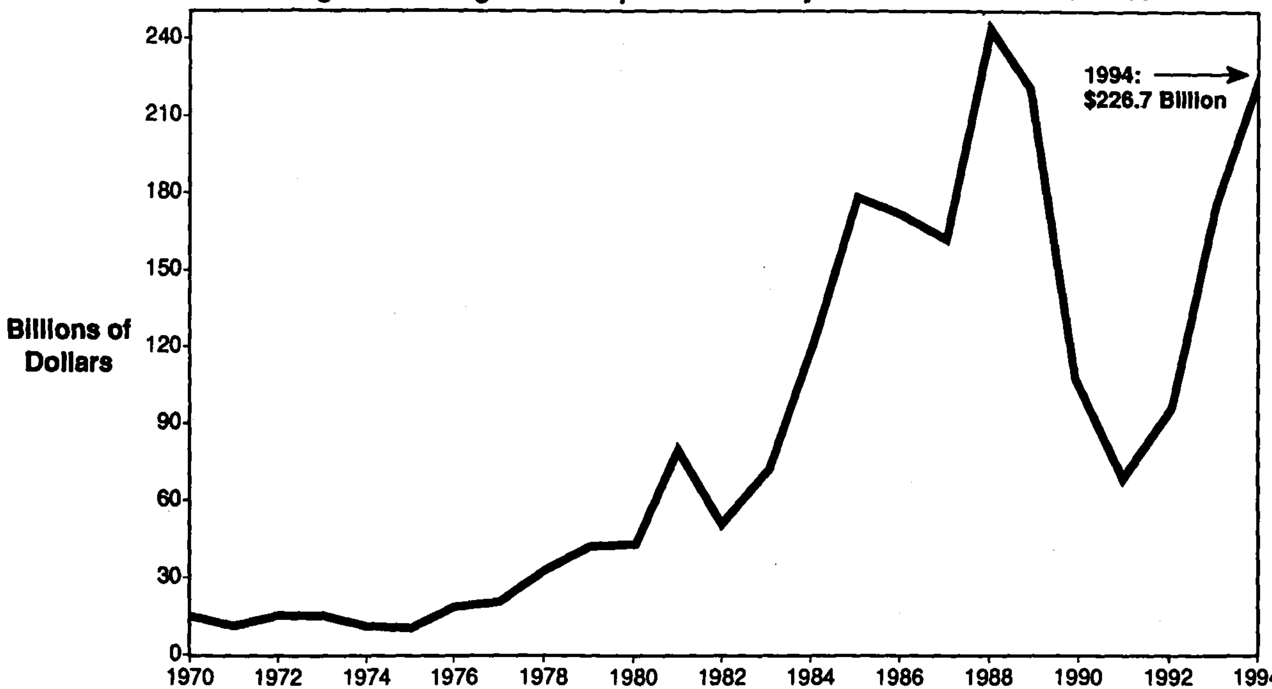
Source: Hatsopoulos and Poterba, "America's Investment Shortfall: Probable Causes and Possible Fixes"

Figure 9: Stock Repurchases in the United States



Source: Securities Data Company

Figure 10: Merger and Acquisition Activity: Total Dollar Value Offered



Note: Includes all transactions involving at least one U.S. firm
Source: Merrill Lynch Mergerstat Review

Figure 11 New Model of Inner City Economic Development

New Model	Old Model
• Economic	• Social
• Private sector	• Government, social service organizations
• Genuinely profitable businesses	• Businesses based on subsidies or mandates
• Inner city as an integral part of the regional economy	• Inner city as an isolated economy
• "Export"-oriented businesses	• Companies serving only the local community
• Engage skilled and experienced minorities in wealth creation	• Social service motivation
• Engage mainstream, private sector institutions	• Create new institutions
• Address inner city disadvantages directly	• Subsidies to counterbalance disadvantages
• Government focused on improving the environment for business	• Government directly involved in providing services or funding

Chairman ARCHER. Thank you, Mr. Porter.

Our next witness is Deborah Walker, representing the American Institute of CPAs.

Welcome. You may proceed.

STATEMENT OF DEBORAH WALKER, CHAIR, TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, D.C.

Ms. DEBORAH WALKER. Thank you, Mr. Chairman and members of this distinguished committee.

I am Deborah Walker, chair of the AICPA tax division, the national, professional organization for certified public accountants. We have more than 320,000 members who advise clients on international, Federal, State and local tax matters and prepare income and other tax returns for millions of Americans.

Our technical policy comments are based on our evaluation of a proposal's complexity, administrability, likelihood of compliance and fairness. As much as we favor simplifying the Tax Code, we realize that simplification cannot always be the overriding criteria.

In some cases, from our base of experience with taxpayers and how laws affect their behavior, we are able, I believe, to comment on the economic or social aspects of the proposal.

The AICPA stands for the proposition that America deserves a more understandable and a simpler tax system that facilitates voluntary compliance. We believe that the present law is unnecessarily complex and, in many cases, difficult to administer and that such complexity fosters noncompliance and lack of trust with the tax system.

The AICPA supports the reinstatement of tax relief for net long-term capital gains. Taxpayers do take tax consequences into account in making their business decisions, and reducing the tax on capital gains will unlock for more productive uses a significant amount of capital that otherwise may stay held in its present form until death. A lower capital gains rate will increase Americans' willingness to save and invest.

However, the AICPA opposes the rules for indexing assets for purposes of determining gain or loss because they are much too complex, they treat different assets differently, and they provide great opportunities for abuse. You need to understand we are not against indexing. Rather, we are against these provisions for indexing.

We do not believe the advantages of this limited indexation provision sufficiently outweighs the creation of added complexity and enhanced opportunities for tax arbitrage. The use of debt will create the greatest opportunity for abuse. The combination of the 50-percent capital gains deduction and indexing of asset basis can result in a negative tax rate. By failing to require indexation of debt and allowing a deduction for interest payments, the negative rate is increased.

Consequently, if this is enacted, tax advisers will doubtlessly urge their clients to borrow as much as possible to acquire capital assets. By allowing a full deduction for interest, which includes an inflation component against investment income, and indexing the basis of assets for determining gain, the tax system gives two deductions for the same inflation. This means that the more debt that is assumed the greater a taxpayer's rate of return. With this provision enacted, tax planners and investment advisers will have the next great tax shelter for their clients.

A simpler way to eliminate income taxes on inflation and avoid this abuse and possible tax shelter creation would be to increase the deduction allowable for long-term capital gains based on the holding periods of the assets. For example, if assets are held from 1 to 3 years, you could have a capital gains deduction of 50 percent. If assets are held for 3 to 5 years, the capital gains deduction would be greater. If assets are held for longer than 5 years, the capital gains deduction would be still greater.

The neutral cost recovery system in the proposed legislation likewise creates unacceptable complexity for the benefits sought. The difficulty of analyzing whether to elect the system or remain on the present system, as well as the tremendous compliance and administrative burdens, strongly suggests an alternative approach.

The AICPA recommends dealing with the inflationary aspects of business property through a substantially broadened expensing provision under code section 179.

We strongly support the efforts to simplify revenue laws and reduce the overall burdens caused by excess government regulation. However, we urge that the Internal Revenue Service and the Treasury Department be excepted from the requirements that would impair the timely issuance of tax regulations.

Because of the complex nature of the code, taxpayers are unable to comply with the law without guidance provided by regulations in many cases. The Tax Code is subject to different interpretations by the IRS and taxpayers, and the absence of regulations increases the likelihood and volume of tax litigation, increasing tax compliance costs.

Many taxpayers we work with prefer the certainty of regulations to the uncertainty of arguing with the Internal Revenue Service over varying interpretations. It is for these reasons that tax regulations are important.

While the AICPA supports the social objectives of the family tax credit and elimination of the marriage penalty, we cannot support these provisions because they basically add another layer of complexity for individuals complying with the tax system. Tax relief for these objectives could be accomplished more simply by a change in the standard deduction or a change in the exemption. In the case of a marriage penalty, the two-earner deduction may be more appropriate.

Finally, the AICPA supports the establishment of the American dream savings account because it expands retirement savings options. It has the advantage of taxing individuals when they can afford it most, during their working years, and not creating an additional tax burden when they can afford it least. Also, taxpayers are likely to place amounts in retirement funds if they know that such funds are available without undo tax burden during times of financial needs.

While we support the American dream savings account provisions, we cannot support the conversion of existing retirement savings assets to these accounts because this does not significantly increase savings.

And, finally, there are a number of technical tax provisions which we have detailed in our written comments on all of these provisions which I would like included in the record. I don't have time to cover them this morning.

Thank you for your attention.

[The prepared statement follows:]

TESTIMONY OF DEBORAH WALKER
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. Chairman, and members of this distinguished committee:

I am Deborah Walker, chair of the Tax Division of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national, professional organization of certified public accountants comprised of more than 320,000 members who advise clients on federal, state and international tax matters as well as prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-size businesses, as well as America's major businesses, including multi-national corporations. Many serve businesses as employees. It is from this base of experience that we offer our comments on the tax proposals contained in the *Contract with America*.

In many parts of the following testimony, we do not comment on the economic or social policy aspects of the proposals but rather restrict ourselves to comments on technical tax considerations and whether the proposal is likely to achieve its objective. In other cases, from our base of experience with taxpayers and how tax laws affect their behavior, our comments may also be based on our view of sound economic or social policy.

Our technical policy comments are based on our evaluation of a proposal's complexity, administrability, likelihood of compliance, and fairness to the taxpayers that are intended to be covered by the provision. As much as we favor simplifying the tax code, we recognize that simplicity cannot always be the overriding criterion.

In our experience, complexity discourage compliance. It can also create unfairness because it can result in otherwise identically situated taxpayers being treated differently solely because of differences in their tax adviser's knowledge.

The AICPA stands for the proposition that America deserves a more understandable and a simpler tax system that encourages and facilitates voluntary compliance. We believe that the present law is unnecessarily complex and in many cases difficult to administer, and that such complexity fosters noncompliance and lack of trust in the tax system. Accordingly, even when we disagree with the methodology for achieving some of the proposed changes to tax law, we have tried to suggest simpler alternatives for accomplishing the objectives. We encourage the Committee, as they progress in their deliberations, to seek information from the Internal Revenue Service regarding the administrability of specific proposals. In addition, the AICPA offers to work with the Committee in any way to ensure that the proposed legislation is workable and will achieve the desired goals.

H.R. 9 - JOB CREATION AND WAGE ENHANCEMENT ACT

Introduction

H.R. 9 significantly revises the tax treatment of capital assets and business property. In our view, the combination of a 50 percent capital gains deduction and indexation of cost basis results in an interplay of new rules that would be incomprehensible to most taxpayers. The Neutral Cost Recovery System (NCRS) likewise creates unacceptable complexity for the benefits sought.

We believe there is a simpler approach that would accomplish most of what is being proposed. We support the capital gain deduction, but suggest it be broadened based on holding period. By allowing a base deduction percentage (say, 50 percent) for assets held from one to three years, a larger percentage deduction for those held three to six years, and a yet larger percentage deduction for assets held over six years, the anti-inflationary aspects of indexing can be approximated. Similarly, as an alternative to NCRS, we recommend a broadening of the present Code section 179 rules, allowing taxpayers greater leeway in deducting currently the cost of depreciable business property.

Sec. 1001. 50 Percent Capital Gains Deduction

The AICPA supports the reinstatement of tax relief for net long-term capital gains. Taxpayers do take tax consequences into account in making their everyday business and investment decisions. Our members see this every day in working with clients. Many taxpayers decide not to devote their capital to what they believe would be the most productive uses because to do so would first require paying income taxes on the gain and inflation inherent in their current investments. We, therefore, believe that reducing taxes on capital gains will "unlock," for more productive uses, a significant amount of capital that would otherwise be held in its present form until the owner's death. A lower capital gains tax rate will increase Americans' (including middle-income taxpayers) willingness to save and invest.

As an organization that has consistently spoken out for simpler approaches to taxation, we are mindful of the concern that reinstating a 50 percent capital gain deduction will restore complexity to the Internal Revenue Code. We do not believe it will. In this regard, it is instructive to note that, in 1986, when net capital gains were subjected to the same tax rates as ordinary income, the complex statutory provisions dealing with such gains were left in the Code "to facilitate reinstatement of a long-term capital gains rate differential if there is a future tax rate increase" (1986 Tax Reform Act Bluebook, p. 179). Even though it eliminated the capital gain deduction, Congress recognized the likelihood that some differing treatment of capital gains would subsequently be reinstated.

Indeed, the real complexity comes from any differentiation in treatment of ordinary income versus capital gain, and the necessary body of law regarding characterization of income as capital or ordinary. Present law taxes capital gains at a maximum rate of 28 percent, rather than the highest ordinary rate or 39.6 percent. Thus, the complexity that results from differing treatment exists under current law and reinstating a 50 percent deduction does not measurably add to complexity.

We have one comment on the effective date of this provision. Since all gains recognized after 1994 would get the benefit of the new deduction, current and future proceeds from pre-1995 installment sales will receive an unbargained-for benefit. However, when capital gain and ordinary income rates were set at the same level, in the 1986 Tax Reform Act, post-1986 gains from earlier year installment sales were subject to an unbargained-for added tax cost (since they lost their 50 percent deduction for amounts received after 1986). The proposed effective date provides "rough justice," and would certainly be simpler than having to maintain two regimes (this proposal and prior law) until all installment sale proceeds from pre-1995 transactions had been recovered.

Sec. 1002. Indexing of Certain Assets for Purposes of Determining Gain or Loss.

The AICPA opposes this provision because it is much too complex, it treats different types of assets differently and it provides opportunities for abuse. AICPA Statement of Tax Policy 9, *Implementing Indexation of the Tax Laws* (1981), recommended that Internal Revenue Code provisions be indexed (generally including asset bases) to minimize the impact of inflation on the tax system. The proposed legislation comports in theory with our prior recommendation, but is significantly more complex and selective in its application. Further, we do not believe it deals adequately with the issue of debt.

The proposal requires taxpayers to use the gross domestic product (GDP) deflator. This number is currently published only quarterly and released after or close to the date estimated tax payments are due for some quarters. The use of quarterly GDP deflators would add another level of complexity and uncertainty for taxpayers required to compute estimated taxes for any quarter. Taxpayers need an annual index, available before the beginning of the year.

Also, for many items (such as a personal residence with subsequent improvements, stocks other than mutual funds with a dividend reinvestment plan), indexing would be difficult because many tax records are currently maintained on an annual basis. Even if records were maintained on a quarterly basis, the sale of such property would require numerous indexation calculations to determine the proper taxable gain or loss.

Furthermore, the fact that property such as options would not be indexed could result in substantial differences in their tax treatment vis-a-vis that of underlying stock, while no substantial difference in economics exists--particularly with respect to long-term options. In an S corporation, the provision specifying that S corporation stock would not be indexed while the assets it holds would be indexed, could result in significant potential differences between outside basis and inside basis in the corporation.

We do not believe the advantages of this limited indexation sufficiently outweigh the creation of added complexity and enhanced opportunities to engage in tax engineering and tax arbitrage transactions. The use of debt will create the greatest opportunity for abuse. Even as proposed, for assets with relatively short holding periods (1-2 years), the combination of the 50 percent capital gain deduction and the indexing of asset basis can - combined with deducting interest on debt assumed to pay for the asset - result in a negative tax rate. In addition, however, by failing to require indexation of the debt or the interest payments, the negative rate is increased. Consequently, tax advisors will doubtless urge clients to borrow as much as possible to acquire those assets. The current return on the capital can be sheltered by the interest deduction on the debt, the sale of the asset will produce a significantly smaller capital gain due to indexing the cost of the asset, and the debt will be repaid at the asset's sale in the same nominal dollar amount as originally incurred - but with dollars that are worth substantially less than they were when the debt was acquired. By allowing a full deduction for interest which includes an inflation component against investment income, and by indexing the basis of assets for determining gain, the tax system gives two deductions for the same inflation factor. This means that the more debt that is assumed, the greater a taxpayer's rate of return on the investment can be.

Assume, for example, that a taxpayer buys stock for $1,000 with a note charging 8 percent interest. Assume further that inflation is 5 percent during the year and the property appreciates 10 percent before sale. With a 50 percent capital gain deduction, the 10 percent before-tax gain is really an 8 percent after-tax gain (assuming a 40 percent ordinary income tax rate). With indexation, the after-tax gain increases to 9 percent. If the interest expense deduction is included in the rate of return, that rate increases to 12.2 percent. The taxpayer has realized a tax benefit for deducting the inflation element of interest expense and adjusted taxable gain for the inflation element of the appreciation, as well as taxing the gain at a more favorable rate.

We are mindful of the language of proposed Code section 1022(h) that a transfer of cash (among other things) from one person to another with a principal purpose of securing an indexation adjustment will allow the Secretary to disallow that adjustment. If subsection (h) is intended to "solve" the debt arbitrage problem, we would caution you that the tracing problems inherent in such a solution will likely be a nightmare. As practitioners, we have had to work with the tracing rules required as a result of some of the changes to the interest deduction rules in the 1986 Tax Reform Act, and we can tell you they provide no easy - and no certain - answers. You might wish to obtain Internal Revenue Service input, as to the ease of working with tracing requirements from their perspective.

A much simpler way to eliminate income taxes on inflation would be to increase the deduction allowable for long-term capital gains based on holding period. For example, a smaller deduction could be provided for net capital gains recognized on assets held more than one year, but less than three years (the proposed 50 percent), with a larger deduction for those held from three to five years, and the largest deduction provided for those held longer than five years. The percentages could be set at any amount Congress deems appropriate. Such a system, with one overall approach for net capital gains, would be much simpler for taxpayers to use.

<u>Sec. 1003. Capital Loss Deduction Allowed with Respect to Sale or Exchange of Principal Residence</u>.

The AICPA supports the policy of allowing capital loss treatment on sale of a principal residence, but believes it should be available for use only against gains on sales of other principal residences. Traditionally, in this country, sales of personal assets at a loss have provided no tax benefit at all, and we understand the case for continuing this treatment. Still, for a very large number of Americans, a home is viewed both as a personal asset and as the biggest investment many taxpayers will ever make. The fact that home ownership has traditionally been encouraged in our tax laws (Code sections 121, 163, 1034) gives added credence to a desire (particularly given the economics of real estate over the past decade) to ameliorate actual or potential economic losses of today's homeowners.

We believe, however, that the proposal goes too far, and needs to be somewhat restricted. It would leave in place the special treatment allowing total deferral of a gain on sale of a principal residence where sales proceeds from the old home are reinvested (within the statutory time) in a new residence, and would also leave in place the absolute exclusion of $125,000 gain for older taxpayers selling their principal residences. A capital loss on the sale of a principal residence would be subject to the regular capital loss rules - no more that $3,000 deducted against ordinary income in a year, and that $3,000 representing $6,000 of the capital loss. These losses will, to the extent possible, be used to shelter other capital gains having nothing to do with home ownership and up to $3,000 of ordinary income.

Thus, for example, we would expect to see many taxpayers utilizing these losses to obtain a "free" step-up in basis for other capital assets they hold, by selling stocks at a gain (a reduced gain, too, thanks to the indexation of basis) and buying them back at current higher prices for no economic cost except the brokerage commissions.

Accordingly, we would recommend that such capital losses be treated consistently with gain on a principal residence and be available only to offset future (or past) gains on sales of principal residences. Where taxpayers have had to reduce the basis of a residence to obtain a tax-free rollover under Code section 1034, a loss on sale of a principal residence could be added to the basis of the next residence acquired.

Sec. 2001. Depreciation Adjustment for Certain Property Placed in Service after December 31, 1994.

The AICPA opposes the Neutral Cost Recovery System (NCRS) because of its complexity and recommends dealing with the inflationary aspects of business property through substantially broadened expensing under Code section 179. The difficulty of analyzing whether to elect NCRS under proposed Code section 168(k) or to remain on the present system (including indexation of basis, should that remain in the new law), as well as the tremendous compliance and administrative complexity of this provision, strongly suggests an alternative approach.

AICPA Tax Policy Statement No. 7, *Analysis of Capital Cost Recovery Proposals* (1980), notes that "in periods of inflation, the simplest and most effective hedge against investment erosion caused by inflation is immediate write-off of capital investment, so that the tax benefits of invested funds are available immediately for further investment. A second hedge is indexation, so that cost recovery is geared to inflation adjusted cost rather than historical cost." Proposed Code section 168(k), providing both indexing and an opportunity cost allowance (the 3.5 percent factor for assets with recovery periods of up to 10 years), would substantially neutralize the tax factor in capital budget decisions.

Tax neutralization, however, comes at the cost of adding great complexity to the Code and to the capital budgeting decision process. At a minimum, every eligible purchase of assets eligible for 200 percent declining balance depreciation will require a decision, even if by default, whether to use the indexing system or to elect out of it. Such a decision would involve analysis reflecting the requirement to use 150 percent, rather than 200 percent, declining balance depreciation, the additional deduction created by the 3.5 percent factor and an assumption as to inflation. The present value effect of these deductions will vary, of course, depending on a given taxpayer's assumed rate of return and future tax rates. This promise of future income tax benefits may be further discounted by taxpayers who remember the rapid reduction in 1986 of the tax benefits conferred on depreciable assets by the 1981 tax act, especially if the cost indexing provisions of section 1002 remain in the new law. The election not to have the new provision apply can be made on a property by property basis necessitating individual calculations for each acquisition.

Confusion is compounded when the asset is sold or otherwise disposed of. The original cost of the asset is reduced under Code section 1016 only by the unadjusted depreciation deductions allowable, but not below zero. For those assets not depreciated under proposed Code section 168(k), proposed Code section 1022(c) provides that the adjusted basis at the time of disposition is indexed for inflation in calculating gain. Comparing the consequences at some hypothetical future disposition will be part of the analysis to be made when deciding whether to use proposed Code section 168(k) or to elect out of it.

From a simplification standpoint, these provisions should not be enacted. The new depreciation system in section 2001 would significantly change computerization needs, as well as tax accounting for tangible property. It appears intended to allow the same benefit as full expensing, but with a much more complicated implementation presumably due to revenue constraints.

A much simpler alternative approach would be to raise the Code section 179 expense amount (currently $17,500, and proposed to go to $25,000) up to say, $50,000 without any phase-out. Another option is to consider an open-ended (or mass asset) account system for depreciation, where there is one account for each recovery period for personal property.

<u>Secs. 7001-7009. Regulatory Impact Analysis.</u>

We strongly support efforts to simplify the revenue laws and to reduce the overall burdens caused by excessive government regulation. However, we urge that the Internal Revenue Service and Treasury Department be excepted from the requirements imposed by this title. We believe the reach of Title VII would impair the timely issuance of tax regulations, which are imperative to the administration of the internal revenue laws.

Under Title VII, Regulatory Impact Analyses, significant additional analyses would be required for any regulatory action that would affect more than 100 persons. Thus, these proposals would, de facto, affect all tax regulations in a manner which we believe would be tantamount to a moratorium on their issuance. This would seriously exacerbate compliance problems which arise from the complexity of our tax statutes. The Internal Revenue Code is not self-governing legislation; it is highly complex in concept and articulation, and in all too many places it specifically leaves to the Treasury Department the responsibility of implementing conceptual rules through regulation.

As Internal Revenue Commissioner Margaret Richardson recently stated: "A significant part of [this country's] noncompliance problem can be attributed to the complexity of the tax code itself, and frequent changes in the tax law." We could not agree more. Because of the complex nature of many areas of the Code, taxpayers are unable to comply with the law without the guidance provided by regulations. Further, those same regulations also set forth binding rules on examining revenue agents and other IRS personnel, giving taxpayers the basis for challenging positions taken by the IRS on examination and in the courts. Because the tax code is subject to different interpretations by the IRS and taxpayers, the absence of regulations will seriously increase the likelihood and volume of tax litigation, increasing significantly the cost of compliance.

Regulations do not always burden citizens. They can be pro-taxpayer or can simplify what the statute has initially made complex. We certainly do not always agree with the positions taken in tax regulations, but we recognize that without them the complexity of the law would leave both the taxpaying public and government agencies unable to apply and administer many provisions with certainty. Many taxpayers prefer the certainty of regulations to the uncertainty of arguing with the Internal Revenue Service over varying interpretations of certain provisions.

Congress is seriously considering making major changes to the Internal Revenue Code this year. Some of them are of unbelievable complexity (look, for example, at the statutory language indexing the tax cost of capital assets, or the provisions intended to alleviate the marriage penalty). The need for regulations, on an expedited basis, would never be greater than the day after these (and many other) tax provisions in the *Contract with America* were enacted.

It probably sounds strange to hear that the private sector would generally welcome regulatory action by the Internal Revenue Service and the Treasury Department. Consider, however, that organizations like the American Bar Association Tax Section, New York State Bar Association, the Tax Executives Institute, and the AICPA - all of whom would seem to have reason to cheer a slowdown in the regulatory process - have asked this Congress to allow the present tax regulation process to continue. We hope you will take all these requests most seriously.

<u>Sec. 12001. Increase in Unified Estate and Gift Tax Credits.</u>

The AICPA supports this provision and recommends that Congress increase the unified credit to bring it in line with the intentions as set forth in 1981--to establish an exemption equivalent that would allow middle class Americans to freely pass property to their children. Furthermore, after the unified credit has been increased to nullify the effect of seven years of inflation, the AICPA supports provisions which index the unified credit to prevent the middle-class from being subject to additional estate tax due only to inflation.

The 1981 *Economic Recovery Tax Act* increased the unified credit, over a six-year period, to its present exemption equivalent amount of $600,000. In 1987, this amount was fully phased in but seven years of inflation have eroded this figure. The unified credit will now only protect $475,000 of property as measured in 1987 dollars. Surprisingly, this erosion has occurred in a period of relatively low inflation. This type of erosion particularly hurt the middle class and many family business owners. As a result, there are many middle-income individuals who find themselves subject to an estate tax that was meant to apply to the wealthy. If the unified credit were adjusted for inflation since 1987, the exemption equivalent would be at least $750,000.

Sec. 12002. Increase in Expense Treatment for Small Business.

The AICPA supports the proposed legislation, but would like to see the adjustment expanded. Attention needs to be paid to the phaseout rules currently in the code. Under today's law, businesses investing over $217,500 cannot take advantage of expensing at all. While that number would go to $225,000 if this section is enacted, the cost of sophisticated equipment is frequently far in excess of $225,000, thereby making this small business incentive for capital expenditure irrelevant for many taxpayers. H.R. 9 would not index this amount, and it would be a very small business indeed that could benefit from the proposal. The AICPA believes this deduction should be allowed in full regardless of the capital expenditures made.

Sec. 12003. Clarification of Definition of Principal Place of Business.

The AICPA supports this proposal , which would modify the U.S. Supreme Court *Soliman* decision, in deference to today's working environment and lifestyles. The proposal clarifies the definition of principal place of business. It allows for the home office to be used for essential administrative or management activities conducted on a regular and systematic basis, where no other office space is provided for such activities.

The technological advances of the past twenty years have alleviated the need for hiring many support personnel and for coming in personal contact with colleagues on a day-to-day basis. As a result, many taxpayers have found it advantageous to work from their homes. Home offices are utilized by sole proprietors, and owners of small businesses operating in partnership and corporate form. In addition, many businesses have found it necessary to promote flexible and alternative work schedules for their employees, balancing work and family issues. As a result many of these employees have set aside a separate area of their homes to accommodate their business needs.

H.R. 8 - SENIOR CITIZENS' EQUITY ACT

Sec. 201. Repeal of Increase in Tax on Social Security Benefits.

The AICPA supports the rollback of tax on Social Security benefits but recommends the outright repeal of Code section 86 (a)(2). This proposal, which would phase-out the repeal of Code section 86(a)(2), creates unnecessary complexity for individuals.

Sec. 301. Treatment of Long-Term Care Insurance or Plans and Sec. 302. Exclusion for Benefits Provided Under Long-Term Care Insurance; Exclusion for Employer-Provided Coverage.

The AICPA supports these provisions, but recommends that certain issues be addressed. Consideration should be given to expanding the provisions to provide benefits and coverage to self-insured employer plans. If an employer self-insures long term care benefits, the tax treatment for employees should not differ.

As a matter of statutory construction, the $200 daily exclusion from income under proposed Code section 818A(e) will be completely missed by most taxpayers and practitioners. At a minimum, a reference to this provision needs to be included in section 137, the cross-reference found in the portion of the Code where income exclusions are enumerated.

While it is clear that the continuation coverage rules do not apply and we do not recommend that this be changed, we do believe that these policies should be completely portable irrespective of employment statutes. In addition, much of this statute refers to individuals but does not consider group or family policies. The statute should consider both individual and family/group policies a likely outgrowth of this legislation as the market for long-term care insurance expands.

Sec. 302. Exclusion for Benefits Provided Under Long-Term Care Insurance for Employer-Provided Coverage.

The AICPA supports this provision which treats premiums for and proceeds from long-term care insurance like other health insurance premiums and proceeds, thus providing parity between long-term care insurance proceeds and other insurance contracts payable on account of sickness or injury. While we understand the need to limit premiums excluded from income based on tax benefits, this will require valuation of the total benefit and possibly an adjustment for the exclusion. It would be more efficient for the tax exclusion for premiums to be based on the premium cost and not the benefits paid.

Sec. 303. Qualified Long-Term Services Treated as Medical Care.

The AICPA supports the adoption of this provision. However, it should provide that the change is not intended to affect the deductibility of items currently allowed under Code section 213(d)(1)(A).

Because the insurance premium deductible by an individual is combined with all other qualifying medical expenses, it is subject to the 7.5 percent of adjusted gross income limitation. Thus, no individual premium limitation based on age is necessary.

Sec. 305. Exclusion from Gross Income for Amounts Withdrawn from Individual Retirement Plans or 401(k) Plans for Long-Term Care Insurance.

The AICPA supports this provision but suggests the need for the clarification of the reporting and withholding requirements by the plan administrator or IRA custodian to take into account the nontaxable nature of these distributions. Furthermore, the AICPA recommends that this exclusion be expanded to all salary deferral retirement plans, such as Code section 403(b) plans.

Sec. 306. Tax Treatment of Accelerated Death Benefits Under Life Insurance Contracts.

We support this proposal and suggest some restrictions on the distribution of the proceeds and consistent treatment of viatical arrangements (contracts for the sale of life insurance policies to third parties where a terminally or chronically ill person has no accelerated death benefit clauses in the life insurance policy).

Accelerated death benefits have become more prevalent in recent years as a source of needed funds for support or medical expenses which may enhance the quality of life for the terminally ill. The tax-free payout of accelerated death benefits to those who are terminally or chronically ill expands the use of life insurance from survivor protection to an expanded type of protection of the insured's estate.

To achieve the stated goals of the provision, the tax-free distribution of proceeds should be limited to the insured or to the insured's guardian.

Sec. 307. Effective Date.

The AICPA supports the effective date of these provisions but recommends that section 306 be retroactive to eliminate existing controversies on the tax treatment of certain accelerated death benefits.

H.R. 6 - AMERICAN DREAM RESTORATION ACT

Sec. 2. Family Tax Credit.

The AICPA opposes this provision because it adds an unnecessary layer of complexity for individuals. Tax relief for this group could be accomplished more simply by expanding the standard deduction and/or the personal exemption. Should, however, Congress determine that a family tax credit is the only acceptable alternative, it should be creditable against the alternative minimum tax (AMT). From both a simplification and policy standpoint, it would appear that taxpayers should qualify for this credit if they have a child who otherwise qualifies as a dependent for federal income tax purposes, as opposed to qualifying for the EITC. Also, while EITC definitions are the reference point for the family tax credit, the EITC is allowed until the child is 25 while the family tax credit is eliminated at age 18. This is an additional reason for avoiding reference to the EITC and relying on the standard deduction or personal exemption.

Section 35(d)(3) states that Code sections 32(d) and (e) shall apply in calculating the family tax credit. The reference to section 32(d) means that married individuals will not be able to claim the credit if they do not file a joint tax return. There are many valid reasons for married individuals not filing joint tax returns. We believe that the filing of a joint tax return should not be a condition for the ability to claim the family tax credit.

Sec. 3. Credit to Reduce the Marriage Penalty.

While we fully support a legislative effort to mitigate or eliminate the marriage penalty, the AICPA opposes this provision both on complexity grounds and because the $2 billion annual benefit bears very little relationship to the magnitude of the marriage penalty in our current tax system. The provision's limitation on the credit to the taxpayers' "actual" marriage penalty will necessitate highly complex parallel tax calculations for millions of taxpayers, since the actual penalty can only be determined after allocating income, losses, deductions, exemptions, and credits between the spouses. Basically, the provision would force all married couples to prepare as many as five federal tax returns, each with a regular and an alternative minimum tax calculation. As an example of how complex this could be, consider the interplay between the proposed American Dream Savings Account and this provision. If one spouse works and the other does not, they are entitled (but only on a joint return) to a $4,000 deduction for an ADSA contribution. On a separate return basis, the nonworking spouse deduction would, presumably, be disallowed to one taxpayer, and any dividend or interest income on that part of the account would be taxed to the other - and all for the limited purpose of determining if there will be any marriage penalty relief.

Also, we call your attention to what appears to be a legislative drafting error resulting in the potential for interpreting proposed new Code section 23(c) to mean (in conjunction with new Code section 23(a)) that each affected taxpayer can claim a credit for the lesser of the joint/single differential or $2 billion, not that the revenue loss from all affected taxpayers should be limited to $2 billion. While this error is easily corrected, difficulties inherent in applying the proposal include how and when the $2 billion amount would be calculated and allocated to taxpayers entitled to it. How could this be determined in enough time to be useful to taxpayers and practitioners in projecting tax liability, monitoring cash flow, and providing planning advice? The added uncertainty would also complicate the timely payment of estimated taxes.

Because of the inherent complexity of the parallel calculations (of which the above ADSA discussion is but one illustration) and the fact that the benefit is based on the income of taxpayers claiming the benefit, we think this provision is unworkable. Alternative approaches should be developed and thoroughly reviewed prior to adoption, with particular emphasis on avoiding undue complexity. One alternative would be the "two-earner deduction," which was in effect between 1982 and 1986.

Also, the "marriage penalty" could be calculated as being equal to the difference between the tax calculated on the joint tax return as prepared and the amount of tax that would have resulted if the taxpayers' married filing jointly (that is combined) taxable incomes were divided in half, with tax calculated using the single tax rate tables. Another alternative is to just increase the tax bracket amounts for married returns or adjust the married filing jointly tax rate, given the predominance of two-earner families at various income levels.

Some other complicated issues that need to be considered in this provision are:

- The various adjusted gross income limitation provisions (such as medical expense, charitable contributions, casualty losses, phase-outs, etc.)
- The Code section 469(c)(7) exception to Code section 469's application to real estate where one spouse qualifies the couple for this provision's benefits.
- The alternative minimum tax, minimum tax credit and net operating loss carryover calculations.
- The definition of the term "legally married." Code sections 6013 and 7701(a)(38) discuss spouses, and husband and wife, but not the term "legally married."

Taxpayers living in community property states are faced with added problems under this provision. Community property and income would have to be divided between the spouses. Any pre-nuptial and post-nuptial agreements would have to be considered for this calculation as well. Alternatively, the federal tax rules could specifically ignore state community property rules and individual agreements.

<u>Sec. 4. Establishment of American Dream Savings Accounts</u>.

The AICPA supports this proposal because it expands retirement savings options in a simple manner. It has the advantage of taxing individuals when they can afford it most (during their working years) and not creating an additional tax burden, as existing retirement vehicles do, when the taxpayer can afford it least (during retirement). Also, taxpayers are more likely to place amounts in retirement funds if they know that such funds are available, without undue tax burden, during times of financial needs. The ADSA addresses financial concerns by making the accounts available, without penalty, for certain qualified distributions. While we support ADSA, we cannot support the conversion of existing retirement savings assets to these accounts.

Also, while considering enactment of these new retirement vehicles, certain issues need to be resolved. Will the taxpayer will be required to allocate withdrawals made from one account among all existing IRA accounts and among qualifying and non-qualifying distributions? To avoid complexity, we believe that distribution from these accounts should be treated independent of other IRA accounts, having no impact on the tax treatment of other IRAs.

A major trap for the unwary is presented in proposed Code section 408A(e). In order to get tax-free status for certain distributions, at least $1,000 must remain in the account. This $1,000 minimum seems inappropriate; a taxpayer who needs money from an account to satisfy the acknowledged purpose should not have to incur the tax. If the goal is to maintain minimum account levels, the requirement should be part of the definition of the account and not a distribution requirement.

The new definitions of qualified special purpose distributions for home purchases, medical and higher education expenses are complex. It seems appropriate to utilize existing Code sections that are already supported by regulations, IRS rulings and other precedents. Qualified distributions should include substantially equal periodic payments. Proposed Code section 408A(d)(2) does not include substantially equal periodic payments in the definition of qualified distributions. Such payments should be included in the definition of qualified distributions for those situations where an individuals retire from the work force before age 59-1/2.

If rollover contributions are allowed, rollover contributions from qualified retirement plans and Code section 403(b) annuities should be allowed. Proposed Code section 408A(c)(5) limits rollover contributions to rollovers from IRAs or other ADSAs. Qualified retirement plans and Code section 403(b) annuities can be rolled over to IRAs. Therefore, taxpayers should be allowed to make a rollover contribution to an ADSA directly instead of being required to rollover qualified retirement plan or Code section 403(b) annuity distributions first to IRAs.

H.R. 11 - FAMILY REINFORCEMENT ACT

Sec. 201. Refundable Credit for Custodial Care of Certain Elderly Dependents in Taxpayer's Home.

While we fully endorse tax legislation to lessen the burden of caring for elderly dependents at home, the AICPA opposes this provision because it adds unneeded complexity to the Internal Revenue Code. The analogous goal could be accomplished by increasing the exemption for these dependents without the complexity of an additional tax credit.

In addition, if these provisions are enacted, the statutory language should be consistent with the language contained in section 301 of the American Dream Restoration Act. Both sections contain definitions of similar terms which, at present, are inconsistent.

Chairman ARCHER. Thank you, Ms. Walker.

Our next witness is Thomas Terry, chairman of the section of taxation for the American Bar Association.

Welcome to the committee. You may proceed.

STATEMENT OF THOMAS D. TERRY, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, D.C.

Mr. TERRY. Thank you, Mr. Chairman.

My name is Thomas Terry, I am the chairman of the American Bar Association's section of taxation.

The tax section is composed of approximately 25,000 tax lawyers located throughout the United States. It is the largest, broadest based professional organization of tax lawyers in this country. Our members live in small communities and large cities—Main Street and Wall Street. We advise our clients on personal tax problems. We work with thousands of small businesses, some that have been around for many, many years and form the economic backbone of their communities and others who are the new, emerging industry leaders of tomorrow. We also represent this country's major multinational corporations, both as in-house counsel and as outside advisers.

This diverse membership base makes its possible for us to offer the committee and its staff a variety of experiences in interpreting and in complying with the tax law. Over the years, the section has sought to make this experience available to the committee on a completely nonpartisan basis, and we are here again to offer our assistance on that basis.

We have prepared detailed technical comments on most of the tax provisions in the Contract With America, and they are included in our written statement. We have intentionally avoided taking positions on economic or social policies. Rather, our comments are intended to assist this committee in crafting rational, understandable and administrable tax legislation.

The section has long worked toward an understandable system that fosters relatively easy compliance. In that vein, we respectfully request the committee and its staff to consider three important matters as they proceed:

First, as the markup decisions are made, we urge the committee to ask whether there are ways to achieve a particular policy result in a simpler, more straightforward manner.

Mr. Chairman, we compliment you for introducing specific bills and, therefore, making the proposed statutory language available to us at this time for public comment. As you know, that has not always been done, and it has been most helpful.

Tax lawyers make their living interpreting the tax law and are often portrayed as having an economic interest in increasing complexity. The truth is that we strongly support every possible effort to simplify both existing law and the new proposals which are under consideration by this Congress.

Second, we ask that you consider the administrability of the proposed legislation.

As the committee's legislative package evolves, we encourage you to actively seek help directly from the Internal Revenue Service. For example, during the legislative process the committee might request the Service to provide a mockup of the relative portion of the tax return affected by a specific proposal. You might ask them to provide you a description of the recordkeeping that taxpayers will be required to maintain and the volume and interpretive materials, regulations and rulings, that the Service expects to publish in order that people will be able to understand and comply with the new law.

With this information in hand, it may then be possible for the committee to revise the proposals during your deliberations in order to increase the administrability of the proposals.

Third, assuming it is not inconsistent with your specific policy objectives, we believe you should try to minimize the extent to which a tax proposal creates an uneven economic playingfield.

As tax lawyers deal primarily in the details of the tax law, we do not presume to substitute our economic judgment for that of the committee. However, our experience in providing tax advice to people and businesses over a period of many years suggests that the tax system is better off, and the American people's perception of the fairness of the system, which is very important, is much stronger if tax legislation generally provides individuals or businesses with similar economic incomes pay the same amount of tax.

We are not elected officials, and we realize the policy choices are yours, not ours.

One additional point. We urge the committee to enact the technical correction provisions which were included in the bill that passed the House in the last Congress. The provisions are truly purely technical, they are bipartisan, they are badly needed, and they ought to be enacted promptly.

We appreciate your consideration, Mr. Chairman. Thank you very much.

[The prepared statement follows:]

TESTIMONY OF THOMAS D. TERRY
ON BEHALF OF THE AMERICAN BAR ASSOCIATION
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
February 1, 1995

ADDITIONAL COMMENTS SUBMITTED FOR PRINTING

The following comments represent an abbreviated version of the technical and administrative analysis prepared for distribution to the Committee. These comments were assembled from submissions prepared by members of the committees of relevant jurisdiction and expertise within the Section of Taxation of the American Bar Association. The longer version prepared for distribution to the Committee included additional comments on the following subjects: family tax credit; capital loss on principal residences; home office deduction; moratorium on regulations; private causes of action; increase in unified estate and gift tax credit; the Senior Citizens' Act; and the Family Reinforcement Act.

I. THE AMERICAN DREAM ACT

A. Reduction of Marriage Penalty

The proposal leaves the design of the credit to the Secretary of the Treasury and provides only minimal guidance as to the policies that should inform that design. We believe that it is incumbent upon Congress to provide specific guidance regarding the form that the credit should take because the proposal implicates various policies.[1]

A significant policy consideration relates to the distributional effects of the credit, which may be greatly affected by the way the credit is implemented. For example, a flat credit up to the amount of a couple's marriage penalty presumably would have a different distributional effect than a credit computed as a percentage of the penalty. We believe that, as elected representatives of the people, Congress is the appropriate body to make such fundamental determinations as the desired distributional effect of a legislative provision.

In determining the proper form of the credit, the Committee may wish to consider additional policy issues such as the following.

1. Limitation of the Credit to the Marriage Penalty Associated with Earned Income

In 1978, the American Bar Association adopted a resolution recommending that Congress amend the Code to provide a credit to offset the additional tax that married individuals pay on their earned income.[2] The reasons for limiting the proposal to earned income included: (i) increased administrability, (ii) reduced taxpayer burden, and (iii) concerns that married couples would shift ownership of income-producing property between themselves so as to maximize the availability of a credit on other forms of income.[3] In addition, one of the chief arguments for providing relief from the marriage penalty is that the penalty discourages the second spouse from entering the work force because a higher marginal rate would apply to the resulting income.

Prior law included relief from the marriage penalty that was targeted to earned income. Specifically, from 1982 through 1986, the Code included a "two-earner deduction" that was intended to reduce the marriage penalty on two-earner married couples. Married couples filing joint returns could deduct from gross income an amount equal to the lesser of $3,000 or 10 percent of the earned income of the spouse with the lower earned income for the year. This provision was repealed by the Tax Reform Act of 1986. The legislative history explains that the 1986 Act's changes in the standard deduction and the tax rate schedules minimized the marriage penalty notwithstanding the repeal of the two-earner deduction.[4]

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1 Various competing policies come into play in connection with the marriage penalty. For example, the tax system tends to view a married couple as a unit and to tax each couple's combined income without regard to the portion of the income earned by each spouse. This view results in horizontal equity between a one-earner married couple and a two-earner married couple with the same total income. This view, however, results in a lack of horizontal equity between a two-earner married couple and two unmarried individuals with the same income.

2 Tax Section Recommendation No. 1978-6, 104 ABA REPTS. 768 (1979).

3 Similar concerns led to the enactment of the so-called "Kiddie Tax" by the Tax Reform Act of 1986. *See* IRC § 1(g).

4 *See* General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, at 19 (1987).

2. The Method for Determining the Amount of the Credit -- Precision vs. Simplicity

If the credit were to be determined precisely, it would be based on a comparison of (i) a married couple's tax liability as shown on their joint return and (ii) the combined tax liability on their separate incomes if they were not married. Unfortunately, determining the individuals' separate tax liabilities as if they were unmarried is complicated in two important ways. First, various judgments must be made regarding the calculation of that hypothetical liability. For example, how should itemized deductions be allocated between the two spouses? Should one spouse be able to claim the standard deduction if the other spouse itemizes? How should exemptions for dependents be allocated? How should various phase-out provisions be applied? Should either spouse be able to claim the child-care credit? These and a number of other issues must be resolved if the amount of the penalty that any given married couple bears is to be determined precisely.[5]

Second, if such a refined system were developed, married couples would have to make the required computations simply to determine whether they were *entitled* to the credit. According to recent estimates by the Service, taxpayers filed approximately 44 million joint returns for 1993.[6] Thus, a very substantial number of taxpayers would be required to make these calculations even though many would find they were not actually entitled to a credit.

A factor to consider in determining the acceptable level of taxpayer burden is the impact of the provision on a taxpayer's total tax liability. As a result of the $2 billion revenue constraint, it is likely that the amount of the credit would be fairly small for a large number of taxpayers. For example, if the proposal resulted in marriage penalty relief for one-half of the 44 million couples who filed joint returns for 1993, the average relief provided would be roughly $91.

Consistent with our general view, we urge the Committee to sacrifice precision for simplicity and administrability. One approach that the Committee might consider is reinstating a provision similar to the two-earner deduction but in the form of a credit. The credit could be set at a certain percentage of the earned income of the spouse who has the lower amount of earned income for the year.[7] The credit also could be capped to limit the revenue loss and achieve any distributional effects that the Committee may believe to be appropriate.

B. American Dream Savings Accounts

1. Major Comments

a. Rollover of Qualified Plan or IRA Funds to an ADS Account. A rollover may be made from an IRA account (other than an ADS account) to an ADS Account prior to January 1, 1998. This provision, coupled with the rollover provisions of existing law, would permit any individual to -- (i) in accordance with plan provisions, withdraw amounts from a qualified pension, profit-sharing, or stock bonus plan, including a section 401(k) plan,[8] or from an existing IRA account; (ii) roll over such amounts either directly to an ADS Account in the case of an IRA account, or to a conduit IRA in the case of withdrawals from a qualified plan; and (3) where a conduit IRA has been used, roll over the amounts from that account to an ADS Account. These rollovers could begin after December 31, 1995, the effective date of the American Dream Act, but could be made only until December 31, 1997.

The American Dream Act provides that upon a rollover into an ADS Account, any amount includible in the individual's gross income as a result of such rollover would be included ratably over the four year period beginning with the taxable year in which the distribution from the pre-existing IRA account is made. Thus, gross income for these years would include employer contributions to a qualified plan (deferred wages), untaxed investment income of the qualified plan, deductible contributions previously made to an IRA, and untaxed investment income of deductible and nondeductible IRA accounts. This treatment is similar to the lump sum distribution treatment that was enacted in the Tax Reform Act of 1986.

These rollover provisions would effectively permit certain employees who have current IRAs or who are covered by a qualified plan to circumvent the required distribution rules for qualified plans in

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[5] Even after resolving all of these issues, any precision would be illusory since taxpayers often would order their affairs differently if they in fact were not married.

[6] *See* Internal Revenue Service, Statistics of Information Bulletin, Fall 1994, at p. 20.

[7] The child-care credit involves a comparable structure. *See* IRC § 21.

[8] *See* IRC § 401(k)(1)(B)(i).

section 401(a)(9)[9] at the cost of paying tax spread over four years on the taxable amounts withdrawn and rolled over. The qualified retirement plan and IRA required distribution rules serve to prevent unintended benefit from qualified plan treatment, which allows contributions to the plan, representing deferred compensation, and income from investment of the employee's interest in the plan, to be accumulated tax-free until distribution from the plan to the employee.

The existence of the front-end tax and the exemption of distributions from current tax means that there is substantially less need for minimum distribution rules, at least during the life of the contributor, in the case of ADS Accounts than in the case of deductible IRAs. On balance, it may not be worth the added complexity to impose lifetime minimum distribution rules on ADS Accounts.

b. After-Death Distributions. Existing law generally provides that benefits payable from a qualified plan or an IRA that begin after the death of the participant must be completed within 5 years after the date of death, unless the after-death distributions meet certain requirements. Because the ADS Account rules do not require distributions after death, an ADS Account could be passed on at death to one or many beneficiaries, to be withdrawn only when and if ever needed, with no tax when the amounts are withdrawn. This exclusion of the amount in the ADS Account from income taxation over successive generations seems hard to defend. Therefore, the Committee may want to consider adopting a minimum distribution rule for ADS Accounts that applies only to after-death distributions.

c. Continued Existence of Nondeductible IRA Provisions. The continued existence of the nondeductible IRA provisions of prior law after enactment of the ADS Account provisions would cause major confusion, as well as major administrative problems for banks and other financial intermediaries maintaining these accounts. We presume it also would cause extreme administrative difficulties for the Internal Revenue Service.

If the ADS Account provisions are adopted, there would be three different types of IRA accounts: deductible IRA accounts, nondeductible IRA accounts, and ADS accounts. The designation "ADS Account" would not avoid this confusion. Many individuals would be bewildered by the range of choices available and would not readily understand the relative benefits and detriments of one type of account as compared to another. It is likely that individuals would (i) make contributions to the wrong type of account, (ii) claim deductions for contributions that do not qualify, (iii) experience difficulty in tracking tax basis for the accounts, and (iv) treat distributions as nontaxable even though deductions were taken.

There is no need to maintain the nondeductible IRA provisions if the ADS Account provisions are adopted. The ADS Account treatment is far more favorable except that the contributions must remain in the account for at least five years unless one of the special exceptions applies. The five year requirement, with the exceptions, is likely to be a very small price to pay for the tax benefits provided by an ADS Account. In order to reduce complexity, ease administrability, and decrease opportunities for tax avoidance, the existing provisions for nondeductible IRA contributions should be repealed for years after the date of enactment of the ADS Account provisions.

In addition, consideration might be given to requiring existing IRA accounts containing solely nondeductible contributions to be treated as ADS Accounts, with the tax upon a deemed withdrawal of the accumulated income in the IRA being payable perhaps over a four-year period after an appropriate transition period, such as one year after date of enactment.

On the other hand, if individuals are to have the opportunity before January 1, 1998, to transfer existing qualified plan or IRA account balances to an ADS Account, paying tax on such distributions over a four-year period, the existing provisions for nondeductible IRAs must be retained until that time unless direct rollovers from qualified plans are to be permitted (*see, infra*).

2. Technical Comments

a. Establishing an ADS Account. An ADS Account would be required to be designated as such by the taxpayer when established. Because of the danger of confusion with other types of IRAs, and to prevent tax avoidance, it should be provided that an ADS Account must be established with that designation in a manner consistent with regulations. This would allow the Service to set up a more definitive and complete set of requirements.

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9 These rules normally require the employee to defer withdrawing amounts until age 59½ and to begin withdrawing the employee's interest in the plan or IRA beginning no later than age 70½. The amounts must be withdrawn beginning by age 70½ in no lesser amounts than will be required to pay out the employee's entire interest in the plan over the life of the employee, or the employee and a designated beneficiary (or the life expectancy of the employee, or the employee and such beneficiary).

b. Time for Contribution. The American Dream Act provides that ADS Accounts are to be treated in the same manner as "individual retirement plans." *See* IRC § 7701(a)(37). It is unclear whether this reference incorporates the existing law rule permitting IRA contributions for any year to be made up to the due date of the taxpayer's return for that year (April 15 of the following year). Although the technical rationale for the April 15 due date contribution rule (this being the time when the deduction is taken) is lacking in the case of an ADS Account, that same rule also is provided under existing law for nondeductible IRA contributions. Failure to afford this treatment of ADS Accounts will cause confusion that could lead to mistakes and disallowed ADS treatment under the five-year rule.

c. Rollover Contributions -- Direct Rollovers from Qualified Plans. Rollovers would be permitted from an ADS Account to another ADS Account, or, as previously described, until December 31, 1997, from any other "individual retirement plan." If the latter type of rollover is to be permitted until December 31, 1997, the provision should simply allow direct transfers or "direct rollovers" from a qualified plan until that date. Requiring the use of a conduit IRA adds complexity and administrative difficulty, both for the taxpayer and the Service.

d. Five-Year Holding Requirement. This requirement would result in contributions to an ADS Account that the taxpayer may have made to supplement his or her retirement savings being subjected to the 10 percent excise tax on premature distributions upon withdrawals after age 59½ but within five years after the contribution date. There is widespread understanding, not easily changed, that retirement savings may be withdrawn without penalty after age 59½. This confusion may be unavoidable, given the apparent objective to limit backloaded IRA benefits in all cases to circumstances in which the contributions remain in the ADS Account for five years or more, unless withdrawn as a Qualified Special Purpose Distribution. However, it would lead to strong complaints, probable abuse, and unjustified criticism of the Service. At the very least, consideration should be given to exempting from the penalty excise tax periodic annuity-type distributions as in the case of regular IRAs. *See* IRC § 72(t)(2)(A)(iv). Such amounts continue to represent a gradually decreasing amount of savings over the life of the annuitant. An exception should be considered for distributions upon death or disability. *See* IRC §§ 72(t)(2)(A)(ii), (iii). The funds may be needed for estate administration purposes, and estates should not be held open for prolonged periods except for the strongest reasons. The five-year holding requirement does not include an ordering rule. Compare section 408A(d)(2)(C) as proposed by Senator Roth in the Savings and Investment Incentive Act of 1995 (S. 12). An ordering rule should be added to the American Dream Act. It should be made clear whether the five-year period begins from the date the contribution was made or the end of the year in which the contribution was made. The tracking of ADS Account contributions, rollovers, allocable earnings, and distributions in order to ascertain compliance with the five-year holding rule would impose major administrative burdens on the responsible party. At the very least, it is critical that clear-cut rules for associating distributions with particular contributions and the investment income allocable thereto be provided. Under section 408(o)(4), individuals who make nondeductible IRA contributions to, or receive any distribution from, an IRA are required to report detailed information to the Service concerning such contributions, as well as historical information on nondeductible contributions and distributions excluded from income. In contrast, institutional payors of such distributions are not responsible for allocating and reporting taxable and nontaxable proceeds. The administrative burden caused by the necessary tracing for five-year holding purposes is likely to result in noncompliance if this burden is placed on taxpayers. On the other hand, the tracking requirement also would be difficult, if not impossible, for payors. Taxpayers could create ADS Accounts at multiple institutions without the knowledge of the institutions and could readily transfer ADS Accounts between institutions (trustee-to-trustee and rollover). Congress should give serious consideration to these administrative burdens, from the standpoint of the taxpayer, the institutions holding the funds, and the Service. A clear-cut allocation of responsibilities should be provided.

e. Special Purpose Distribution Rules in General. A distribution would not constitute a Qualified Special Purpose Distribution if it caused the aggregate ADS Account balances of the taxpayer to fall below $1,000. It is not clear whether the entire distribution which causes this result would be treated as failing to qualify as a special purpose distribution, or whether only the portion below the $1,000 floor would be so treated. In general, it is unclear why the $1,000 limitation is necessary, given the limited purposes for which such distributions may be made. The provision adds complexity and increases administrability problems. We think the Committee should consider deleting this limitation.

f. Qualified First-Time Homebuyer Distributions. A qualified first-time homebuyer distribution could be received for reconstruction of a residence, as well as for acquisition or construction, but a first-time homebuyer is defined as a person who had no present ownership in a principal residence during the three-year period ending on "the date of acquisition of the principal residence to which this paragraph applies." Presumably, it is intended to permit reconstruction of a first-time homebuyer's existing residence. Drafting clarification is required. The Date of Acquisition rule provides a binding contract test for acquisition of a principal residence, but such Date is the date on which construction or reconstruction is commenced for these latter cases. We suggest that the binding contract rule be used also for construction or reconstruction since the dates on which construction or reconstruction begins can be controversial. The special rollover rule for a delay or cancellation of the purchase or construction of a residence also should be extended to the reconstruction of a residence.

g. Qualified Higher Education Expenses. Consideration should be given to expanding the definition of these expenses to include descendants of a son, daughter, stepson, or stepdaughter. We note that S. 12 also includes ancestors of the taxpayer and his or her spouse. We note also that room and board expenses are included in higher education expenses for section 401(k) purposes. Treas. Reg. § 1.401(k)-1(d)(2)(iv)(A)(*3*). We note an apparent drafting error in that the American Dream Act includes no sections 408A(e)(3) and (4).

h. Qualified Medical Expenses. Long-term care expenses other than insurance premiums do not constitute qualified medical expenses. Long-term care expenses of a disabled taxpayer or enumerated relative may not be covered by insurance and may not qualify as medical care as defined in section 213(d). Costs of caring for a parent in the taxpayer's home that are not covered by section 213(d)(1)(A) are common. A parent of the taxpayer receiving social security benefits, or a child with some income, sufficient in either such case to disqualify that person as a dependent, nonetheless may depend heavily upon the taxpayer for assistance in paying medical costs. The Committee should review these limitations to make certain that they reflect its intentions as to the coverage of the proposal and to clarify the interaction of these provisions with the long-term care exclusion provided by the Senior Citizens' Act.

II. THE JOB CREATION ACT

A. Capital Gains Exclusion and Indexation

1. Introduction

Title 1 of the Job Creation Act would modify the tax treatment of capital gains in three ways. First, proposed section 1201 would allow taxpayers to deduct 50 percent of their "net capital gain" in computing AGI.[10] Second, proposed section 1022 would allow taxpayers to increase their basis in "indexed assets" to reflect inflation. Finally, proposed section 165(c)(4) would allow individual taxpayers to deduct losses arising from the sale or exchange of a principal residence.

In 1975, the American Bar Association recommended that Congress enact a system of indexation of tax basis to eliminate the taxation of nominal gains attributable to inflation.[11] The ABA Tax Section has neither adopted a formal position on the need for, or advisability of, preferential treatment for capital gains income nor does it take any such position before this Committee. The Tax Section's membership reflects the same range and diversity of views on these ultimate policy issues that is found in the nation as a whole. However, as tax professionals who interact daily with taxpayers who must attempt to comply with the tax laws, we have a strong interest in participating in the enactment process to assure that the Congress enacts provisions that are understandable by taxpayers and administrable by the Internal Revenue Service. We generally believe that those objectives are best achieved by reducing ambiguity and increasing simplicity whenever possible.

2. Capital Gains Deduction -- Section 1001 of the Job Creation Act

The Job Creation Act would add proposed section 1201, which would permit both individual and corporate taxpayers to deduct 50 percent of their "net capital gain" in computing AGI.[12] This deduction would replace the current limitation on the maximum tax rate on net capital gain for individuals contained in section 1(h) of the Code and the alternative rate for corporations contained in section 1201. The Job Creation Act also would repeal section 1202, which was enacted in 1993 and generally allows an individual taxpayer to exclude from gross income 50 percent of any gain from the sale or exchange of "qualified small business stock" held for more than five years.

A fifty percent deduction would be a powerful incentive to convert ordinary income into capital gains. Our experience suggests that taxpayers would engage in tax planning to take advantage of this differential.

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[10] A capital gains exclusion would also reduce state income taxation in states that follow the Federal definition of AGI.

[11] *See* ABA Legislative Recommendation 75-4. The recommendation did not and could not anticipate the specific structure of section 1002 of the Job Creation Act.

[12] The Job Creation Act also makes a series of conforming changes to other provisions of the Code; an additional conforming change is needed for section 453A.

The combined repeal of section 1(h) and section 1202 may have an unintended effect on individuals who have invested in "qualified small business stock." Section 1(h) limits the maximum tax rate on net capital gain to 28 percent. Thus, as a result of the 50 percent exclusion for qualified small business stock, taxpayers are subject to an effective maximum tax rate of 14 percent (50 percent of 28 percent) on any gain from such assets or 21 percent if the individual is an AMT taxpayer. By repealing section 1(h), the maximum tax rate on any gain from such assets would increase to 19.8 percent (50 percent of 39.6 percent) for taxpayers who are not AMT taxpayers. In addition, because under the Job Creation Act the 50 percent deduction would only apply to "net capital gain" (*i.e.*, the excess of net long-term capital gains over short-term capital losses), an investor in qualified small business stock would lose all benefits from such investment to the extent the investor had short-term capital losses. We recognize that there is a tension between the goal of simplification we have endorsed and the remedy of providing transition relief to taxpayers who would benefit from existing section 1202. However the Committee chooses to resolve those competing considerations, the availability of transitional relief and the issue of the effective date of the repeal of the current provisions should be explicitly addressed.

3. Indexation -- Section 1002 of the Job Creation Act

The Job Creation Act would add proposed section 1022, which would permit a taxpayer to increase basis in certain "indexed assets" to reflect the impact of inflation during the taxpayer's holding period. The "indexed basis" of the asset would be used for computing gain or loss on the sale or other disposition[13] of the asset.[14] On the other hand, the provision would not apply for purposes of determining depreciation, depletion, or amortization of the asset or for any other purpose.[15]

The Job Creation Act indexes capital assets but does not index debt. While we recognize that the decision not to index debt is a policy judgment, and that indexation of debt raises a number of difficult issues (particularly with respect to financial intermediaries), we wish to alert the Committee to the fact that the failure to index debt will create tax arbitrage opportunities. As experienced practitioners, we expect that taxpayers will enter into tax-motivated transactions designed to exploit such opportunities.

a. Periodic Indexation. Proposed section 1022(e) would provide that the basis of an asset is adjusted quarterly for inflation. Adjustment of basis on a strict quarterly basis may cause taxpayers to delay the sale or other disposition of indexed assets until the beginning of a new quarter in order to obtain the maximum increase in basis (thus minimizing any gain that they may recognize). To avoid such behavior on the part of taxpayers, the Committee should consider permitting taxpayers to adjust the basis of indexed assets by interpolation. Thus, for example, the basis of an indexed asset sold on the 30th day of a quarter could be adjusted by 30/90ths of the inflation occurring during the preceding quarter.

On the other hand, the Committee could greatly simplify the indexing provision by permitting only annual adjustments in basis for inflation. For sales occurring in the middle of the year, taxpayers might be allowed to adjust the basis of any assets sold by interpolation based on the previous year's inflation. For example, for a sale occurring on the 50th day of a year, the basis of an asset could be adjusted by 50/360ths of the inflation occurring during the preceding year. This would eliminate recordkeeping on a quarterly basis and would avoid confusion due to issuance of preliminary and revised inflation figures.

b. Definition of Indexed Asset. An "indexed asset" is defined as (i) stock in a corporation and (ii) tangible property (or any interest therein) that is a capital asset or that is property used in a trade or business as defined in section 1231(b). Explicitly excluded from the definition of an "indexed asset" are (i) a creditor's interest in property, (ii) options, (iii) net lease property, (iv) non-participating preferred

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13 A distribution on common stock that is not a dividend would be treated as a disposition for these purposes. Does this mean that indexed basis would be available to absorb return of capital distributions? The legislative history should explicitly address this issue. In addition, it would be desirable to clarify how indexation should affect the calculation of earnings and profits for purposes of determining what constitutes a return of capital.

14 Although new section 1022 would apply for purposes of determining losses as well as gains from the disposition of indexed assets, to the extent that new section 1022 would create or increase a net ordinary loss to which section 1231(a)(2) would apply, or an ordinary loss to which any other provision would apply, the loss would be treated as long-term capital loss. The Job Creation Act does not make clear how this limitation would be computed. We simply note alternative possibilities: (i) compute gain for each asset using indexed basis and then net total gains and losses or (ii) net gains and losses on an unindexed basis for this purpose.

15 Some clarification of the interaction of indexation with depreciation and similar basis adjustments is required. For example, if a machine is purchased for $100 and depreciated on a straight line basis over 10 years, to what amount of basis (for purposes of determining gain or loss on disposition) will indexation apply? Alternatives include (i) indexation of the original basis without depreciation or similar adjustments and then subtracting the adjustments from the indexed basis on disposition, (ii) applying the indexation adjustment only to the adjusted basis at the time of disposition, or (iii) some intermediate approach that attempts to account for the taxpayer's varying investment in the property over time.

stock that is fixed and preferred as to dividends,[16] (v) stock in a foreign corporation, and (vi) stock in an S corporation. The effect of this definition is to exclude intangible assets such as patents, copyrights, licenses, and similar assets from indexation as well as partnership interests and other interests in unincorporated pass-through entities.[17]

To the extent that lines are drawn between assets subject to indexation and assets not covered, new controversies will arise. While the policy rationales for the explicit exclusions to indexation (such as debt) in the Job Creation Act may be controversial, the explicit exclusions are understandable and generally appear to be capable of reasonably clear delineation. The rationale for departing from the long established definition of a capital asset in defining an "indexed asset" in section 1022(a) is less clear, and the Committee should carefully consider whether the decision to allow indexation of the stock of a corporation holding primarily intangible assets while denying the adjustment to the assets themselves will create unnecessary ambiguity and controversy.[18]

c. Pass-Through Entities.

(1) In General. In general, indexation under proposed section 1022 would not apply to interests in pass-through entities such as partnerships and common trust funds.[19] S corporations are explicitly excluded, apparently to maintain parity between partnerships and S corporations for this purpose. The rationale for denying the indexation adjustment to these interests while providing the indexation adjustment for other entities such as regulated investment companies ("RICs") -- also known generally as mutual funds -- and real estate investment trusts ("REITs") should be more clearly articulated.

Under proposed section 1022, partnerships, S corporations, and common trust funds would pass through any basis adjustment to their equity holders. However, no mechanism for these pass throughs is specified. The Committee should articulate, in at least a general way, how it envisions that such adjustments would be made. For example, if a partnership sells an indexed asset at a gain, a portion of which is protected from taxation by the indexation provision, then distributes the proceeds of the sale to its partners, what will be the mechanics of the pass through? To illustrate, suppose that A and B each contribute \$100 to Partnership X which uses the \$200 to buy corporate stock. Two years later, X sells the stock for \$300 at a time when its indexed basis is \$250, then distributes the \$300 in proceeds to A and B. A and B will each have gain of \$25, which will increase their bases in their partnership interests to \$125 each. But each partner will receive \$150 on the distribution and unless each receives a \$25 adjustment to partnership interest basis for the indexation adjustment, taxation of the distribution will negate the indexation benefit. If a basis adjustment for the partnership interest is made, when is it to be made: at the time of sale of the underlying asset or when a distribution is made? If a partnership has a section 754 election in place, how will indexation apply to the adjustment to the basis in the partnership's assets? How would indexation affect the inside and outside basis reductions required under section 108(c)? Would indexation create a greater difference under section 732 between liquidating and non-liquidating distributions by a partnership? Similar questions arise for other pass-through entities.

In its current form, the provision implicitly requires the Treasury Department to write regulations specifying how indexation is to apply with respect to these types of pass-through entities. If it is intended to delegate such authority to the Treasury Department, the delegation should be explicit. In addition, the Committee should consider whether indexation for pass-through entities can be made effective until basic regulations for pass throughs are published. The better solution would be to include at least basic rules for the intended pass through in the final Job Creation Act.

(2) RICs and REITs. A specific rule is provided under proposed section 1022 for interests in RICs and REITs. Interests in RICs and REITs are eligible for indexation based on the ratio of the value of indexed assets held by the entity to its total assets, with a 10 percent de minimis rule applicable

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16 The impact of this exclusion on convertible preferred stock should be clarified.

17 It is not clear how the provision is intended to affect intangible oil and gas expenditures that the taxpayer has elected to capitalize. It would seem that such expenditures should qualify based on their relationship to the underlying mineral interest, which is eligible.

18 For example, would incorporation of a company having primarily intangible assets run afoul of new section 1022(h) as a transfer to increase the indexation adjustment? If section 1022(h) is retained in the final Job Creation Act, substantial effort will be required to clarify its intended scope. Examples of cases in which the Committee believes the provision should and should not apply would be particularly helpful.

19 Interests in pass-through entities (other than S corporations, which are explicitly excluded) would not be included in the definition of indexed assets since they are neither stock in a corporation nor tangible property.

at both the high and low ends (*i.e.*, all interests qualify if the entity holds 90 percent qualifying assets and no interests qualify if it holds less than 10 percent qualifying assets). Mutual fund shares can be bought and sold with relative ease, and account balances are often shifted between funds within a family of mutual funds. For this reason, the Committee should consider mechanisms to provide shareholders in such entities with the information they need to report accurately gains on sales of their shares.

d. Other Issues.

(1) Failure to Qualify During Holding Period. The Job Creation Act would provide that indexation would not apply during periods when an asset does not qualify as an "indexed asset." No guidance is offered, however, with respect to relatively short periods of disqualification. As an alternative, section 1022 could provide that an asset qualifies for indexation if it meets the requirements of an indexed asset for a specified portion of the taxpayer's holding period (for example, 80 percent). This would avoid complex adjustments for minor periods of ineligibility. While it appears that it is not intended that periods of ineligibility will "restart" the indexation period, this should be made explicit.

(2) Short Sales. Proposed section 1022 also would provide that the amount realized on a short sale of an indexed asset would be indexed for inflation. Thus, a taxpayer who sells short an indexed asset and more than one year later buys that asset back would have to index the amount realized (*i.e.*, the amount realized on the original sale) for inflation. This provision may alter taxpayer behavior because it creates an incentive to close out any gain position in a short sale before the end of a year in order to avoid having this provision increase gain.

The Job Creation Act also would provide that a taxpayer will not be entitled to index an asset during any period in which it has sold short an asset that is substantially identical to another asset it holds. There is no explanation as to how a taxpayer would calculate the reduction in the "applicable inflation ratio" for periods when such a short sale is outstanding. Arguably, since the applicable inflation ratio is a function of full years during which the taxpayer held the asset (or during which a short sale was outstanding), this provision should only apply to short sales which, in the aggregate, last no more than one year (or, when netted against the taxpayer's holding period, reduce that holding period to a smaller number of whole years). Moreover, this provision may be inappropriate if indexation already applies to the amount realized in a short sale.

(3) Dispositions Between Related Persons. Basis indexation would not apply to dispositions of property between persons who are "related" under section 267(b) or who are treated as a single employer under section 414(b) or (c), except to the extent that the transferee of the property takes a substituted basis in the property. The policy rationale for this provision is not clear. In any event, it is not clear why indexation should be permanently lost (as opposed to deferred) on a related party sale. For example, if Parent sells corporate stock that Parent has held for two years to Child at the market price, Parent will pay tax on any gain without benefit of indexation. In addition, Child's eligibility for indexation will apparently begin on Child's purchase date. Thus, two years of indexation available to unrelated taxpayers will be permanently lost to the family. This loss might be ameliorated by providing Child (and other related purchasers) with the ability to tack Parent's holding period for purposes of indexation. Absent some such amelioration, there will be substantial pressure on the anti-avoidance rule with probable significant increases in controversies as taxpayers seek mechanisms to preserve indexation benefits in transfers involving related parties.

As drafted, the related party rule would encompass distributions of appreciated property under section 311(b) to a stockholder who owns more than 50 percent of the distributing corporation's stock. Given the overall objectives of the proposal, this result appears to be unintended.

(4) Separate Asset Rule. The Job Creation Act provides that substantial improvements to property, substantial contributions to capital of corporations, and other portions of assets "as appropriate to carry out the purposes of this section" will be treated as separate assets and hence will have different indexation periods from the underlying asset to which they relate. While the rationale for this rule is clear, its application is not. In particular, the Committee should define "substantial" for this purpose in objective terms (such as a percentage of value or basis of the underlying asset). In addition, the "other portion" rule should apply only to the extent provided in regulations. Absent such clarification, these provisions are likely to give rise to substantial disputes.

(5) Interaction with Section 1258. The Job Creation Act should address the intended interaction between the proposed indexation provisions and section 1258 (regarding recharacterization of gain from conversion transactions). Section 1258 recharacterizes as ordinary income any gain recognized by the taxpayer equal to the amount of interest the taxpayer would have earned on its net investment at 120 percent of the applicable Federal rate. Applying section 1258 in conjunction with basis indexation under proposed section 1022 would eliminate ordinary income recognition on the inflation component of the gain.

B. Neutral Cost Recovery

1. Complexity Issues

The systemic change occasioned by NCRS would be the third to the depreciation regime since 1980, the predecessors being ACRS (1981) and MACRS (1986).[20] NCRS could result in complexity that could cause difficulty for taxpayers in three respects: (i) calculating the increases in depreciation deductions; (ii) making property-by-property calculations, if required, instead of bottom line group calculations; and (iii) calculating basis adjustments, if required, for recapture or for other reasons.

a. Ease of Calculation. To be readily usable by smaller business taxpayers, the NCRS formula should be susceptible to being expressed in straightforward tables that could be included with return instructions. Computing the inflation adjustment on a quarterly basis, however, would make these tables fairly cumbersome. The Committee may want to consider whether is it possible to use annual or semiannual inflation adjustments rather than quarterly adjustments.

b. Bottom-line Calculation. Because the inflation and return on investment depreciation would have no effect on the basis of property (section 168(k)(7)) or on depreciation recapture, we see no need for a property-by-property calculation. We suggest that the Committee consider expressly providing that taxpayers may calculate the inflation and return on investment amounts on the total depreciation for 3-, 5-, 7, and 10-year property placed in service for a given year and may calculate the inflation amount on other property in such groupings as are appropriate given the decisions made with respect to the quarterly versus annual or semiannual inflation adjustments discussed above.

c. Basis Considerations. Proposed section 168(k)(7) would provide that the basis of assets and the basis of any pass-through entities are not adjusted to account for the additional inflation or return on investment depreciation. Advantages of the no-recapture rule are avoiding calculation of the additional depreciation on a property-by-property basis and consistency with the exclusion of the assets from basis indexation under proposed section 1022. Institution of any basis adjustment or recapture system would greatly increase the complexity of the provision.

2. Other Issues

Our longer submission prepared for distribution to the Committee addressed the following additional Neutral Cost Recovery issues: pass-through entities; integration with basis indexation; normalization; coordination with interest deductions; and anti-churning rules.

C. Regulatory Reform

There is no question that the federal regulatory process needs to be constantly monitored and corrected when it results in the imposition of undue regulatory burdens. We have urged, and continue to urge, the Service and Treasury to adopt regulations that minimize administrative burdens. However, the proposal of a blanket application of an additional set of requirements on the tax regulatory process is misguided, and would produce greater rather than lesser taxpayer burden. The special needs of taxpayers and tax administration have been recognized in past regulatory reform initiatives and should continue to be recognized as the current proposals are examined. In the past, tax regulations have been exempted specifically from many of the requirements to which they would now be subject.

In current practice, tax regulations in both proposed and final form are accompanied by a preamble in which a number of the criteria listed in Title VII of the Job Creation Act (section 7004(c)) are addressed. In other cases the proposed criteria are not relevant. For example, most tax regulations are interpretative, not legislative, regulations. This means that they are issued to provide interstitial guidance with respect to the interpretation of frequently complex and comprehensive sets of laws enacted by the Congress. Before enacting Internal Revenue Code amendments, Congress has the opportunity to consider costs and benefits and to take into account the number of taxpayers affected. In the case of interpretative regulations, the Service and Treasury must follow the expressed intent of Congress in order to issue a valid regulation; they cannot second guess Congressional policies that are fixed by the language of the underlying Code section.

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[20] Given the background of frequent change to the depreciation rules, many taxpayers may not be comfortable with the use of NCRS, which would require use of a less advantageous (150 percent versus 200 percent declining balance) depreciation method in exchange for the deferred benefit of additional inflation and return on investment depreciation. A taxpayer would be disadvantaged in the early years of the property's life and benefitted by the additional depreciation in the later years of the property's life. Given the history of frequent change to the depreciation rules, taxpayers may fear that the deferred benefit will never be realized.

Apart from the fact that current practice satisfies the relevant regulatory impact policies, the imposition of more procedures onto the already burdened process of tax administration would be counter-productive. Subjecting tax regulation, for which there is a large backlog already, to even more procedural hurdles risks bringing the entire process to a halt.

For example, we believe that if provisions such as the indexing of asset basis and proposed individual retirement account rules are enacted, prompt regulatory guidance will be essential to their implementation. Adding new procedural obstacles to tax regulations would inevitably delay by many months the publication of universally applicable guidance, to the detriment of important new Congressional tax policies.

We share the desire of Congress for clear, concise, simple, and unburdensome regulations. Such regulations are possible and highly desirable in many areas, particularly those touching a large number of moderate income taxpayers. However, in certain areas the goal will be unattainable, both because of the complexity of the Code and the complexity of transactions occurring in the marketplace. If proposed section 7006 (concerning complex language) is enacted, it is reasonable to predict that one of two things will happen. Either the section will be ignored on the basis of a general claim that its requirements have been satisfied "to the extent practicable," or the Service and Treasury will diligently attempt to carry out the literal mandate and that effort will delay further the issuance of needed guidance; neither outcome is particularly desirable.

The application of Title VI to tax regulations could be particularly damaging. Under section 6001, the current law provision that makes the required regulatory analysis nonreviewable by the courts would be repealed. Apparently, anyone who felt aggrieved by a tax regulation could complain to the courts that there was some flaw in the regulatory analysis and that the regulation, therefore, should not apply. The opportunity for mischief here would be too great to tolerate in the tax system. The procedure in section 6003 that would require the final regulations to be approved by the Small Business Administration is also potentially disruptive. Code section 7805(f), enacted in 1990, already provides for Small Business Administration involvement in the writing of tax regulations without requiring an additional level of agency approval. Requiring separate approval of one more agency, as a practical matter, would create significant delay and confusion for taxpayers in need of guidance.

The foregoing comments relate specifically to interpretative rulemaking of the sort involved in the great majority of tax regulations. The Congress, however, sometimes delegates legislative rulemaking authority to the Treasury. The tax-writing Committees may wish, in appropriate cases involving such delegation, to specify regulatory procedures, tailored to the tax law context, that address concerns such as regulatory impact and opportunity for notice and comment. However, we urge the Congress not to place additional procedural obstacles in the way of tax regulations as a general matter.

Title V of the Job Creation Act concerns "information collection requests," which are defined in 44 U.S.C. § 3502(11) and enlarges some of the current requirements of those rules. Those rules do not now burden taxpayers or tax administration to any significant extent. Accordingly, Title V is not addressed.

Title VIII of the Job Creation Act is called the "Citizens Regulatory Bill of Rights," and appears to be targeted to regulations other than tax regulations. The recent legislation and proposed legislation known as "Taxpayer Bill of Rights" legislation, on the other hand, is targeted to tax regulations, among other things, and has been the subject of extensive analysis and testimony by the Tax Section. If the "Citizens Regulatory Bill of Rights" also is intended to apply to tax regulations, a wide range of changes would be necessary to accommodate the tax administration system. We contemplate making additional comments regarding Title VIII, but at this time we note one specific concern. Section 8101 of the Job Creation Act provides that each person that is the "target" of a Federal investigation or enforcement action has several specified rights upon the initiation of "an inspection, investigation, or other enforcement proceeding." These rights include the right to remain silent, be warned that statements may be used against them, and have an attorney or accountant present. It appears that, absent modification, this provision could apply in the case of an ordinary audit by the Service, which likely would create unnecessary anxiety for audited taxpayers and might result in a lack of taxpayer cooperation that would hinder the Service's audit process.

Chairman ARCHER. Thank you, Mr. Terry.

Our next witness, David Walker with the Association of Private Pension and Welfare Plans. Welcome to the committee. You may proceed.

STATEMENT OF DAVID M. WALKER, MEMBER, BOARD OF DIRECTORS, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, D.C.

Mr. DAVID WALKER. Thank you, Mr. Chairman. Thank you for the opportunity of being here and appearing before yourself and the other distinguished members of the committee.

My name is Dave Walker. I am a partner with Arthur Andersen. I am a member of the board of directors of the Association of Private Pension and Welfare Plans—also known as APPWP. I also serve as one of two public trustees for the Social Security and Medicare system and formerly as an Assistant Secretary of Labor for ERISA and head of the Pension Benefit Guaranty Corporation.

I am here today to represent the APPWP on the important topic of savings and investment in general and pension savings in particular. As you know, APPWP is the largest and most diverse trade association dedicated to employee benefit plan matters.

I have submitted a statement for the record, Mr. Chairman, and would now like to proceed to summarize the most important elements.

First, I would like to compliment the committee on holding these hearings and focusing attention on this important topic. While much attention has been focused on the twin Federal budget and trade deficits, not enough attention has been focused on an equally, if not more important, deficit, and that is our savings deficit. Our savings deficit is real and requires immediate attention and decisive action.

This savings deficit has an adverse effect on our ability to sustain long-term economic growth, create jobs, maintain our competitive posture and to improve the overall standard of living of Americans. It also has a detrimental effect on the economic security of Americans in their retirement years.

As a retirement policy expert with significant firsthand public and private sector experience, I can assure you and this committee that this Nation is facing a severe retirement crisis which needs to be addressed. Several key indicators of this looming retirement crisis include the following:

First, the projected financial imbalance in the Social Security and Medicare programs, of which Medicare is particularly acute; second, the declining pension savings and participation rates; third, low personal savings rates; fourth, our aging society, longer lifespans, our increasing dependency ratios, escalating health care costs, declining private sector retiree health coverage rates—just to name a few—in addition to the Federal budget deficits.

Pension plans play a critically important role in helping to ensure the economic security of Americans in their retirement years. The factors that I mentioned will serve to increase the need for both pension plan savings as well as individual savings. However, our current tax and regulatory policies serve to discourage rather than encourage pension savings.

Numerous studies have been commissioned or conducted by APPWP, EBRI and others pointing out the importance of pension savings and the need for related tax and regulatory reform. Several are referred to in my statement.

Employee benefits professionals have been aware of this need and have been engaged in a longstanding battle to increase the visibility and priority of pension savings issues. Recently, chief executive officers of some of the major corporations of America have recognized the increasing importance of this issue and have joined the battle.

In fact, I am proud to say that Larry Weinbach, who is chairman of our global firm, is heading a related task force with the committee on economic development, which is comprised solely of CEOs, and plans to publish a comprehensive, candid and constructive paper in May of this year which will deal with this issue and make a number of specific tax and regulatory reform proposals.

All of these studies, both the ones referred to in my paper and others, demonstrate the need to raise the priority of pension savings and related legislative and regulatory reform matters. In particular, they point out the need to, among other things, raise the maximum contribution of benefit limits applicable to qualified plans, return the full funding limit for qualified plans to its pre-OBRA 1987 levels, simplify pension regulations, especially the nondiscrimination rules, facilitate retirement planning and investment education initiatives by employers and correct the currently flawed tax expenditure calculation methods and assumptions accorded to qualified pension plans.

In summary, pension savings are critically important to the economic security of America and Americans in their retirement years. Congress needs to raise the priority of pension legislative issues and take steps to increase pension savings and address the looming retirement crisis. While additional individual savings vehicles and incentives may be warranted, they should not come in lieu of much-needed pension, tax and regulatory reforms.

I thank you, Mr. Chairman and members of the committee, and would be more than happy to answer any questions you might have.

[The prepared statement follows:]

TESTIMONY OF DAVID M. WALKER
ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

My name is Dave Walker. I am a Partner at Arthur Andersen LLP and a member of the Board of Directors of the Association of Private Pension and Welfare Plans on whose behalf I am testifying today. I also serve as one of two Public Trustees for the Social Security and Medicare Trust Funds. Previously, I served as Assistant Secretary of Labor for the Pension and Welfare Benefits Administration for the Department of Labor, and as Acting Director of the Pension Benefit Guaranty Corporation (PBGC).

The APPWP is a national trade association for companies and individuals concerned about federal legislation affecting all aspects of the employee benefits system. The APPWP's members represent the entire spectrum of the private pension and employee benefits community: Fortune 500 companies, banks, insurance companies, law, accounting, consulting, investment and actuarial firms. APPWP members either sponsor directly or administer employee benefit plans covering more than 100 million Americans.

I am pleased to have the opportunity to discuss the importance of savings in America, the subject of these hearings. This is a vitally important topic because of savings' direct effect and far-reaching implications concerning the economic security of our Nation and Americans in their retirement years.

Much of the focus of these hearings to date has been on personal savings. Indeed, personal savings is a critical component in ensuring adequate retirement income as well as sources of capital for economic growth. However, the U.S. personal savings rate has generally collapsed since 1980. This collapse in personal savings has increased the pressure on other elements of savings, both Social Security and the employer sponsored pension system. Unfortunately both the Social Security (OASI) and Medicare (HI) programs are encountering their own fiscal problems. The baby-boom generation will greatly increase the retired population in proportion to the working population early in the next century. This will dramatically increase the burden on these important social retirement programs. In addition, the Medicare program is facing escalating costs and is unsustainable in its present form. According to the 1994 Trustees' Annual Report, unless current funding is increased and/or benefit promises are reduced, projections indicate that Medicare will run out of funds in the year 2001 and Social Security will run out of funds in the year 2036. This means that a dark cloud looms over the retirement horizon. However, the one clear bright light in an otherwise dark and dismal savings trend for our country and its retirees has been savings through the private pension system.

It is critical as we review the national policy towards personal savings that we bear in mind that no single element of savings can bear the burden of providing adequate income for this country's retirees as well as the capital necessary for maintaining growth in our economy and improving the standard of living for all Americans. We recognize and applaud your efforts to encourage personal savings. However, we urge you not to forget the vital role that the private pension system plays in overall national savings. In this regard, it is critical that we adopt and maintain legislative and regulatory policies which foster the growth and strength of this system.

It is the importance of this country's pension system to national savings that I would like to focus on in the remainder of my testimony, today. In particular, I would like to discuss the role that pension plans play in the economy. In addition, I would like to share some insight into the current tax expenditure calculations which include those tax expenditures attributed to the employer sponsored pension system. Finally, I would like to offer some recommendations for improving the environment for private pension plans and ultimately to increase our overall savings rate.

Role of Employer Sponsored Pension System in the Economy

The role of the private pension system in providing meaningful retirement income to a sizable portion of the American workforce is well documented and understood. What is less appreciated by those outside the benefits community is the critical role pensions play in the overall American economy. The place to start is with the sheer size of the employer sponsored pension system. In 1950, the system contained approximately 17 billion and accounted for 2% of national wealth; today it has been estimated to contain about $4.0 trillion and constitutes 25% of national wealth. Of this sum slightly less than three quarters are held by private employer plans with the remaining one quarter being held by public sector employers. By 1992, private employer pension plans alone held nearly one quarter of the nation's equities and approximately 9% of the economy's fixed income holdings.

Much of the growth in pension assets in the early years of the period since 1950 was stimulated by enlightened legislative policies. In 1974, ERISA required employers to set aside specific assets to help assure that promised pensions would be paid. Equally important, ERISA forbade employers sponsoring defined benefit plans from holding more than a modest amount of employer securities, in effect requiring that employers invest the substantial majority of pension assets elsewhere. At the same time, individuals who were responsible for the management and administration of plans and the investment of plan assets became subject to a number of stringent fiduciary standards.

However, since 1980 much of the growth in private pension assets is attributable to a strong investment performance. While the rest of the economy was being deregulated during the 1980's, the budget reconciliation process has resulted in unreasonably curtailing the tax incentives and funding policies related to pension plans. While the ultimate outcome of this activity has been the reduction in pension security for retirement promises made to active employees, there has also been a profound effect on the level of national savings (and hence capital formation) that could be achieved through the pension system.

Furthermore, benefit payments from pension plans have increased at a faster rate than contributions; reflecting the increased burden being placed on this system to provide retirement benefits as personal savings have declined. Unfortunately, defined benefit plan contributions suffered sharp decreases beginning in the latter half of the 1980's. Contributions to defined benefit plans declined from $48 billion in 1982 to $ 25 billion in 1989. Although contributions to defined contribution plans continued to rise during the 1980s, reflecting the increased number of this type of retirement plan, the increase in the rate of contributions did not keep up with the increased rate of payments from these plans. (EBRI, Pension Funding & Taxation, Implications for Tomorrow, Edited by Dallas L. Salisbury and Nora Super Jones, 1994, page 24).

While some of the decrease in the rate of contributions is attributable to increased earnings on financial assets, much of the blame can be laid on tax policies implemented beginning in the 1980's which severely curtailed the growth in new retirement plans and the funding of existing plans. In addition, the dramatic increase in the cost of maintaining a retirement plan has been a barrier to the growth and continued maintenance of these plans.

Specifically, the following represent a sample of several tax changes which have had a detrimental effect from a capital formation and retirement security perspective:

1. Reduction of maximum pensions. Commencing in 1982 and in legislation in succeeding years, Congress rolled back the maximum benefit and contribution limits applicable to tax qualified pension and profit sharing plans. In addition, freezes on the maximum dollar amounts which could be paid from tax qualified plans were imposed on defined benefit plans and defined contribution plans. A freeze on the maximum limit is still in effect on defined contribution plans.

The trend has continued into this decade. Just last year the amount of compensation which can be taken into account when calculating benefits was reduced. Furthermore, in the recently enacted General Agreement on Tariffs and Trade new rounding rules on the cost of living adjustments effectively reduce growth in contributions to retirement plans.

While ostensibly an "attack" on unreasonable benefits for highly compensated individuals, the unfortunate aspect of these rollbacks is that it has a negative ripple effect on non-highly compensated workers and adversely impacts a company's ability to set aside funds for all current workers necessary for retirement. For example, employers may not make contributions on behalf of middle income workers whose projected pensions would exceed current limitations.

2. Reduction in Full-Funding Limitations. In 1987, Congress reduced the maximum amount that could be contributed to pensions from one which permitted employers to set aside funds to pay for projected benefit obligations to one which imposed an arbitrary limitation equal to 150

percent of current liabilities. As a result, depending on plan demographics and other factors, (e.g. interest rates), it is possible for a plan to be at the full funding limit and yet still pay risk related premiums to the PBGC.

3. Additional Tax Rules. Over the decade of the 1980's, Congress and the Treasury Department added an additional 80 pages to the Internal Revenue Code and over 600 pages of regulations. The pension area has become so complicated that the sheer complexity and administrative expense associated with maintaining a pension plan has become a significant barrier to those who wish to start and/or maintain a pension plan. According to a Hay-Huggins study done for the PBGC, the administrative costs associated with maintaining a defined benefit plan, rose during the 1980's on average between 9 and 10 percent a year. According to a soon to be published report by the Committee for Economic Development, (Who Will Pay For Your Retirement? The Looming Crisis, Lawrence A. Weinbach, Chairman, William J. Beeman, Project Director, December 20, 1994, *Draft*, page 117) in 1991 small plan administrative costs (15 or fewer employees) were equal to about one-third of the benefits accrued in that year. That means for every $3.00 contributed to a pension plan $1.00 went to pay for the cost of maintaining the plan.

According to this same report the number of defined benefit plans peaked at just over 175,000 in 1983 and subsequently declined by 24 percent in the 1984-1989 period. In fact by 1989, for every defined benefit retirement plan that was being created three were terminated. While terminations increased by 37%, net plan formation fell by 67%. The picture for 1990 was even more bleak: for every defined benefit plan which was created, more than eight were terminated. Although there has been overall growth in the number of defined contribution plans since the mid-1970's even this type of plan is not immune to the increasing administrative costs. In 1990, more defined contribution plans, the other major form of retirement plan, were terminated than created.

Indeed, part of the decline in the number of defined benefit plans may be associated with the shift from manufacturing industries which traditionally sponsor defined benefit plans to service based industries, which do not. However, most observers believe that the legislative changes noted above had a major deleterious effect on plan formation.

The Committee for Economic Development cites a survey conducted in 1992 in which 50% of the respondents stated that they terminated their defined benefit plans because federal regulations were too costly or burdensome. Furthermore, the data indicates that a large number of employers who terminated defined benefit plans did not replace them with successor pension plans of any kind, and most of those who did so opted for defined contribution plans. The report recognizes the important role that defined contribution plans play in the viability and growth of our nation's pension system. It concludes, "these trends indicate that it is critical that policy makers simplify and stabilize regulations pertaining to defined contribution plans in order to reduce compliance costs. In addition, survival of the remaining 130,000 defined benefit plans and the retirement security of their 40 million participants, may depend to a significant degree on policy makers' actions that influence plan administrative costs." (Who Will Pay For Your Retirement? The Looming Crisis, December 20, 1994, *Draft*, page 119).

Pensions Are How America Saves

At the very time pension plans were being burdened by negative legislative and regulatory policies, there was a general collapse in personal savings. This further increased the burden on employer sponsored plans. The EBRI reports in Retirement in the 21st Century Ready or Not, (edited by Dallas L. Salisbury and Nora Super Jones, 1994, page 40) that the national savings rate fell from 7.1 percent during the 1970's to 3.8 percent during the 1980's and to 1.8 percent thus far in the 1990's. Business and personal savings accounted for about one-half of the decline and the federal deficits accounted for about one-half of the decline.

The pension system represents a significant store of wealth for retirement security and overall economic growth. According to the EBRI, annual accumulations in such plans are not fully accounted for in traditional measures of savings (EBRI, Retirement in the 21st Century, Ready or Not, page 40). In fact the one bright spot in the otherwise dismal domestic savings picture during the 1980's and 1990's has been the growth in pension assets. Americans' accrual of significant wealth in their pension plans resulted in an astounding fact: the total increase in real (inflation-adjusted) pension assets in the 1980's exceeded the total real increase in this country's wealth (i.e. the money available for investment). In other words the growth in pension assets was greater than 100% of net national savings. (APPWP, Return on Investment: Pensions Are How America Saves, Professor John Shoven, Stanford University Economics Department, September 1991, page 22). Clearly this form of national savings has been vital not only for the economic security of retirees but also for the necessary investments for national economic growth and global competitiveness.

Pension Tax Expenditures

Besides its enormous size and its role in national savings, pensions represent the most egalitarian form of capital formation. A 1987 study conducted for the U.S. Census Bureau showed that the largest beneficiaries of tax deferrals afforded to pension plans were workers with yearly incomes between $15,000 and $50,000. These workers paid 35.6% of all federal income tax collections but actually received 60.7% of accrued pension benefits. Those workers with yearly incomes of more than $50,000 paid 61% of the federal taxes but received only 38.1% of the accrued pension benefits. (Fat Cats, Bureaucrats and Common Workers: Their Piece of the Pension Preference Pie, Gordon P. Goodfellow and Sylvester J. Scheiber, The Wyatt Company, May 5, 1993, p.15).

Rank and file employees are indeed benefitting under pension plans. For instance, a 1991 study by the EBRI showed that U.S. workers earning less than $50,000 a year made up 92% of the nation's work force and 89% of the participants participating in pension plans. (EBRI, Issue Brief #134, February 1993, p.17). No other form of savings so broadly attaches to the middle class.

Yet, the magnitude and distribution of the "tax expenditure" for pensions repeatedly has been used as a justification for tax policy that has damaged the pension system in this country. "Tax expenditures" represent the cost to the government as a result of granting tax incentives. The tax expenditure estimates for pensions are calculated by placing a cost on the granting of a tax deferral to employees for contributions made by their employers to pension plans. The most current estimates of the tax expenditure attributable to pension contributions and earnings, including both public and private sector plans, is $72.5 billion in 1995. Approximately one-half of this figure is attributable to public plans and one-half is attributable to private sector plans. (United States Senate, Committee on the Budget, Prepared by the Congressional Research Service, Tax Expenditures, December, 1994, page 477).

The estimate does not take into account the fact that the tax is deferred not forgone. Thus, the fact that contributions to a plan will be paid out in the form of benefits at a later date and subject to tax at that time is ignored. In addition, the role of pensions in the economy and its investment value is totally missed. There are, in addition, a number of mathematical and methodological problems with the calculations. For example, the tax expenditure estimate includes consideration of pension contributions made by governmental and tax exempt employers. In addition, demographic effects such as the maturity of the plans' work forces are ignored. Yet as the population ages the tax expenditures will lower automatically. Also, the calculation ignores the fact that coverage, and the value of that coverage, typically increases during a career and that tax rates could rise and some people will actually pay higher taxes as a result of the deferral. Finally, the calculations completely ignore the funded status of the plans.

Recommendations

Future economic growth in America and the economic security not only of retirees but of all of our workers and their families depends on readily available capital for investment. Our most important ally in increasing our capital pool over the last decade and a half has been pension funds. According to the Committee for Economic Development private savings is only a fraction of that needed to enable future retirees to fulfill their economic expectations in retirement. One recent study showed that the baby-boom generation needs to triple its rate of accumulation of assets in order to maintain its pre-retirement standard of living during retirement. (Merrill Lynch, Is the Baby Boom Generation Preparing Adequately for Retirement?, *Technical Report,* 1992, B. Douglas Bernheim, Stanford University Economics Department, formerly of Princeton University, and Summary Report of the same title, 1993, page 1).

We can and we must streamline and simplify the rules applicable to pension plans. Congress has twice passed legislation in 1992 which would begin to untangle the legislative and regulatory gridlock currently ensnaring the pension system in this country. However, the legislation was attached to a broader measure that was vetoed for unrelated reasons. We must encourage the formation and funding of pension plans and limit compliance costs. Based on the current population survey, the greatest percentage of workers not covered by pension plans in this country work for employers that do not sponsor a plan. We believe that legislation simplifying the rules applicable to pension plans would give a tremendously needed jump start to the formation of plans.

Tax policy affecting the pension system should allow employers the flexibility to use the plan design which is most appropriate for their work force and their business. As I mentioned earlier administrative burdens have made the adoption and/or maintenance of a retirement plan increasingly unattractive to employers. This is particularly true in the case of defined benefit plans. We urge you to look for ways to make these plans attractive to employers once again.

Defined contribution plans have accounted for virtually all the growth in the number of active workers covered by private plans. Between 1975 and 1987 the proportion of covered workers with a defined contribution plan as their primary plan rose from 13% to 32%. Most of the growth in defined contribution plans is occurring in a type of plan known commonly as a Section 401(k) plan, in which the participant makes a contribution and the employer makes a matching contribution. (EBRI, National Academy on Aging, Pensions in a Changing Economy, Edited by Richard V. Burkhauser and Dallas L. Salisbury, 1993, page 25). These plans have become attractive to employers in part because of the shift to a service oriented economy but also because of their simplicity and understandability. However, even these plans are not immune from legislative and regulatory complexity.

The single most unattractive feature about these plans is the complicated nondiscrimination test which must be performed annually. This test generally does not affect the highest paid employees whose contributions are limited by the dollar caps on contributions. Instead the effect of this test is to reduce the amount that can be contributed by and on behalf of the middle income wage earners. Unfortunately, the affected workers are often older and are trying to maximize their contributions in order to prepare for retirement. We urge you to include in pension simplification legislation a meaningful safe-harbor which would eliminate the necessity of employers having to run the expensive and unnecessary nondiscrimination test applicable to Section 401(k) plans.

As defined contribution plans have grown and a wider range of investment opportunities have become available to participants, employers have recognized the need to educate their employees about the importance of participating in pension plans, investment for the long term and saving generally. The market has responded with a wide variety of educational materials. Since this is a relatively new area for employers and those servicing retirement plans, it is unclear what affect the educational efforts are having on participant behavior. However, early indications are that the efforts are being rewarded. There are currently a number of studies underway to help determine what educational approaches work best and what effect education has had thus far. However, it is clear that the more Americans are made aware of the importance of savings, early participation in pension plans and their responsibility for both, the better their chances for being prepared for retirement. We urge Congress to be very careful that policies adopted in the name of protecting and empowering participants do not hurt the ability of employers to provide useful and much needed retirement planning and investment education to their employees.

We also urge you to reconsider and correct the calculation of the tax expenditure associated with the pension system in this country. In addition, national policy should not sacrifice the future of America's workers and their children by giving in to the temptation to pay for the federal deficit with pension savings. The federal deficit eats away at national savings. Congress should not address that problem by weakening our greatest source of savings, pensions.

We support and encourage your efforts to expand personal savings but caution you to recognize that increasing personal savings by reducing the incentives for employers to maintain pension plans will not solve the savings crisis in this country. In addition, Americans must be encouraged to save by creating attractive savings vehicles. This may include allowing early access to the savings. However, no one component of savings - personal or pension - should be favored in this regard. The favorable tax treatment traditionally granted in America to pension contributions and the earnings thereon stand as a monument to the recognition of the importance of the economic security of our retirees and the significant role that pensions play in our nation's overall economic well-being. Thank you.

Chairman ARCHER. Thank you, Mr. Walker. Your timing was perfect.

I will yield my time for inquiry to Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Porter, you mentioned in your testimony the special connection between equity investment and productivity growth that leads you to emphasize specific changes in tax treatment of equity and debt. Would you mind elaborating why that is so?

Mr. PORTER. Yes, Congressman. Equity has a special role in boosting productivity and creating economic growth because equity capital is what companies use to finance intangibles like R&D and entering new markets. You cannot use debt—there is no collateral for those kind of investments. And when you are building new products and entering new markets, you really finance that out of equity. Debt is what you use to finance safe things where you have hard assets.

Also, equity capital allows you to add debt capital on top of it, so you can get a double whammy. I believe that we must place particular attention on the incentives for equity investment, and, among equity investment, long-term equity investment. Because it is long-term equity investment that is really what funds the things that drive our economy forward.

Mr. BUNNING. Also, today our economy grows between the rate of 3 to 4 percent on an annual basis. I was taught in economics 1 and 2 when I went through school that that was good, and even 5 and 6 percent was better. I also was taught that low interest rates were good, and I was taught that inflation—high inflation—was bad.

What has happened in the thinking of the Federal Reserve—or whoever is trying to set the economic policy in this country—that all these things are not as good as they might be because we are at full capacity? And why are we at full capacity if we are only growing at 3 or 4 percent?

Mr. PORTER. I think that is a very important question, and it is not very often discussed.

The fact that at only 3 or 4 percent economic growth we are straining at capacity and worried about inflation I think is a function of the very low rate of net investment in the economy. Remember what I said earlier was that in the sixties and seventies our net investment, which is investment after depreciation in the corporate sector, was 3 to 4 percent of GDP. Now it has fallen to 2 percent of GDP.

So if the economy is growing at 3 or 4 percent and the net investment is at 2 percent, you can see why we are straining at capacity. And unless we can boost the rate of net investment in the corporate sector, particularly as in the ways I have discussed, we are going to face that situation for a long time. We will have a cap on how fast our economy can grow without setting off inflationary pressures.

Mr. BUNNING. Ms. Walker, you mentioned in your testimony about capital gains and the length of time that we hold capital assets that we should probably adjust how we deal with that asset in direct relationship to how long we hold it. You mentioned 3 and 5 years.

Is there anything that you would like to add to that? In other words, I would like to see us get into indexing at least and at least try to do something if we could phase in a capital gains tax reduction over a 5-year period. I am willing to do that just to get it going.

Ms. DEBORAH WALKER. And the AICPA supports indexing.

The problem is, when we look at the provisions for indexing and even look at provisions that have been introduced in the past, we very quickly get into rules that are just too complicated, and then our thoughts go to, well, because we have to keep these extra records and find GDP deflators and make all these calculations and project forward, would it not be easier if we just had a different exclusion based on the holding period of assets?

So the capital gains exclusion takes into account what indexing otherwise could do as a simpler way to get to the same point. Does it exactly do what indexing would do? Of course not.

Mr. BUNNING. No, but it allows us to take a capital asset and at least consider the fact that there has been inflation and the longer we hold the asset the less value it has as far as the asset is concerned.

Ms. DEBORAH WALKER. Or the less of the gain that should be taxed, because the more of the gain that is really inherent inflation. Correct.

Mr. BUNNING. Correct.

Chairman ARCHER. Would the gentleman yield just briefly?

Mr. BUNNING. Yes.

Chairman ARCHER. The unfortunate reality, Ms. Walker, is that it can end up not even being a rough approximation of indexing if inflation becomes very rampant. A mere sliding scale holding period cannot accommodate the destruction of capital—real capital savings if you are taxing portions of inflation. If you assume inflation is going to stay constant at 3 percent, you could perhaps adjust a scale of taxation. But we all know that that is not the way life works. So I would simply point that out from a policy standpoint that would not work.

There is also another problem which we have run into every time we have considered a sliding scale of holding periods. You create cliffs and you then begin to impact on economic judgments and I think Mr. Terry said we want to keep as level a playingfield as possible out there. So your solution creates its own set of problems.

I thank the gentleman for yielding.

Mr. BUNNING. Well, thank you. I yield back.

Chairman ARCHER. Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

I have a question for Professor Porter. In your statement there is a lot of which I agree with. However, you do have a section here on overinvestment in real estate, and you indicate that the tax consequences are some $82 billion. However, I think your recommendations will not do much, if anything, to decrease that tax consequence. Even if you cap interest and principal on mortgages at $350,000, that is not going to net very much at all.

You do not cite a figure for restricting the free tax rollover, but the question I have is—and it is probably more in the form of a statement—that for the bulk of Americans, their main asset is their home. And, yes, because that is the case, the tax consequences will be relatively high. But if we are to start tampering with the tax-free rollover, what I find in my district is a young couple, before the kids, they buy a little starter home with two bedrooms; they move into the next home with four bedrooms; roll over that profit, and that is how they increase their major asset.

So I think your statement here that we are overinvesting in real estate is somewhat misstated, because, for the people I am talking about and the folks I represent, they do not have the wherewithal and the money to buy blocks of IBM and GM and help with equity capital and things of the type you have talked about.

Mr. PORTER. May I respond briefly, sir?

Mr. KLECZKA. Yes, please.

Mr. PORTER. I guess the point I want to make about real estate is simply, first of all, the balance. I think the number we discovered from doing the calculations is that 50 percent of all the net investment in the U.S. economy is in residential real estate. Fifty percent. And I guess the idea is that that sounds high in terms of an economy where we are trying to grow our economy, create new jobs, and create a rising standard of living.

My recommendations are about trying to limit this incentive for affluent people. So I said our premium is if the combined first and second home equity is $350,000, then we will cap the deduction at that. And the same applies to the rollover.

The idea is if—you know, you can roll over maybe $100,000 of tax-free gains. But if you are rolling over $2 million, we are no longer talking about the middle-class person. We are no longer talking about that struggling young couple. I think we have to have the wherewithal and the courage to start scaling back some of these investments if we are really serious about boosting investment in the private sector.

That is my only point.

Mr. KLECZKA. But if we would adopt the program you are recommending, I would say that we will take that 50 percent figure you just used of investing in real estate, and we will probably reduce that to maybe 48 percent. Thank you.

Mr. PORTER. It is true that the absolute dollars are in the $5 to $10 billion range, but that is still a lot of money per year.

Mr. KLECZKA. I would not minimize it because, knowing full well that investments in homes and building homes, the spinoff is throughout our whole community, not only the jobs in construction but the other services and items that are purchased for the home. So the spinoff is pretty good also. Pretty widespread.

Mr. PORTER. But not as high as a company investing in a new plant and creating 100 new jobs.

Mr. KLECZKA. That is true, but the bulk of the people who are in that 50 percent category do not have the assets to do that.

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Porter, you were answering Mr. Bunning's question, and my attention was diverted, and I missed part of your explanation. I am very interested in what you said at the very end. I think I heard you say that there would be a cap on growth for the next few years. Is that what you said?

Mr. PORTER. What I said, sir, was that, given that the net rate of investment in fixed plant and equipment in the U.S. economy is only 2 percent of GDP, which it used to be much higher, used to be double that, if we grow at faster than 2 percent of GDP, eventually we are going to run out of capacity. And instead of investing in new plant and equipment, what American industry has been doing in the last 10 years is they have been buying back stock and making acquisitions.

I am not against either of those things, but what I am saying is those do not create net new capacity in the economy that allows us to have true economic growth. It changes ownership.

So that is why I, in my testimony, put special attention on how we can increase the flow of equity capital, which is what really fuels investment in creating new plants, new businesses and new jobs.

Mr. MCCRERY. I am just a lawyer, I am not an economist, but if we have growth in productivity, then we can increase economic growth to 4, 5 or 6 percent, like Mr. Bunning wants, and not have inflation. Is that a fairly correct general statement?

Mr. PORTER. Yes. But, again, you cannot increase productivity without also increasing capacity or you really cannot have growth.

Another problem we have had is the downsizing process. And that allows us to make our existing assets more productive, but it has not allowed us to really expand.

I think what is happening is that there is an imbalance developing between the amounts of new investment and—for example, I show in my statement a calculation about productivity growth. What it shows is that almost all the productivity growth spurt in the last 10 years has been productivity in volume terms. You hold the price constant, and you can make more of the same products.

But if you look at the value productivity growth, the dollar value of the output, actually productivity growth continues to be very, very slow. What is happening is that industries are not able to sustain price increases. They are not producing new products that they can charge high prices for. We are getting more efficient in cranking out the old products, but we are not expanding and upgrading enough to support rising wages.

I have some charts on that in my testimony.

Mr. MCCRERY. Is there any provision in the Contract With America—I assume you have looked at the provisions in the Contract—that would help solve that problem?

Mr. PORTER. Well, I believe that the single most powerful provision is the long-term capital gains incentive. As I said in my testimony, I, myself, believe that we should limit that to equity capital, equity investment in corporations, because I do not believe that other forms of investment, like collectibles and so forth, have the same leverage for economic growth.

I would also make that long-term investment truly a long-term incentive, either through a significant—more than 1 year—holding period or some kind of a step-up, as my fellow panelists suggested, recognizing the Chairman's concerns with the step-up are well taken.

And in order to lower the cost of that proposal, which is, I know, a large one, I would make it prospective. That is, I think that although it is tempting to think in terms of the old investment that you are going to unlock, I think it is much better to create incentives for the new investors today to be choosing investment projects that they plan to hold.

Mr. MCCRERY. Are there any tax provisions in the Contract that you think would be disadvantageous?

Mr. PORTER. I think there are tax provisions that we can debate in terms of their value versus their cost. But I don't think they would work against long-term equity investment, as I understand them.

Mr. MCCRERY. Thank you.

Ms. DEBORAH WALKER. Indexing of capital gains, I think, might do that, where you do not index the debt because that will encourage debt acquisition as opposed to equity acquisition.

Mr. PORTER. Fair enough.

Ms. DEBORAH WALKER. Indexing capital gains without paying attention to the debt is a significant problem.

Mr. MCCRERY. Thank you.

Chairman ARCHER. Has the gentleman completed his questioning?

Mr. MCCRERY. Yes.

Chairman ARCHER. You still have 1 minute left, if you would not mind yielding to me.

Mr. MCCRERY. Be happy to.

Chairman ARCHER. In that regard, the difficulty with indexing the debt is that you have to index both sides of the debt, and you get some very, very untoward results. So, in theory, you might say that that levels the playingfield. It distorts the level playingfield in the mind of a debtor who cannot take the deduction for the full amount of the interest because you have eroded the value of the interest payment.

So you have to be very, very aware of all the ramifications of what you are talking about.

I thank the gentleman for yielding.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I want to thank this panel of expert witnesses for your testimony. I would like to address my question, please, to Mr. Walker.

I certainly share your concern for the low rate of savings. In fact, I am alarmed—and I use that term advisedly—when I read Dr. Feldstein's studied conclusion that were we to put all of our personal savings into plant and equipment in this country today, we could not sustain long-term economic growth. I think that is a real indictment. It certainly goes to the point that not only you, Mr. Walker, but the others on the panel made.

But in addressing my question to you, you talk about the importance of the private pension system and promoting savings. You also mention some of the complexities that have been layered into the private pension system over the past few years. Would you just elaborate on the complexity? How it has affected growth and the viability of the pension system?

And, in particular, how, in your judgment, have the tax policies of the last 10 to 15 years affected the private pension system? And now that we are looking at reforming those tax policies, how would you prioritize the reforms?

I guess those are three—at least a three-part question, but I am primarily interested in this: In your judgment, how would we reform the Tax Code to undo some of the damage?

Mr. DAVID WALKER. Thank you.

First, let me say that I believe that the elective and regulatory requirements that apply to qualified pension plans are probably the most complex of any in Federal law. I spend full time practicing in the compensation benefits area, and it is extremely difficult for me to be able to stay on top of these issues. And now we are having to have subspecialists in various areas because it is almost impossible to stay up. Which means there is a tremendous amount of cost, there is a lot of administrative burden, and frankly, it is almost impossible for people to be able to comply with the law even if they wanted to comply with the law.

Specifically, what has happened, I think over the last several years is, all too frequently policy has been dictated by short-term revenue results rather than long-term savings and investment objectives. We have made a number of decisions as a country that are myopic, that have tunnel vision implications.

In particular, I think we need to look very hard at what we have done in the area of the contribution in benefit limitations, where we have continuously eroded those, where we have placed arbitrary limits on the ability of defined benefit plan sponsors to adequately fund their pension promises. And, in some cases, it has had not only a deleterious effect on savings but also on retirement security.

I think that we have to look at regulatory burdens and particularly the 600, roughly, pages of nondiscrimination regulations that apply to pension plans, especially defined contribution plans.

I think that we need to—I could probably go on for quite a length of time, and I would be more than happy to provide some additional information for the record, if you would like, because APPWP has done a tremendous amount of work and has a number of studies that I think that might be helpful to you and other members to get into more specificity. But we have to take a longer term view.

[The information is being retained in the committee files.]

Mr. DAVID WALKER. And the last thing is we have to revise how we calculate tax expenditures. I am a CPA, among other things, and it is amazing to me that the Congress does not employ present value methodologies in calculating tax expenditures. The country is not going to go away in 3 to 5 years.

The fact of the matter is that many of the tax expenditures that are accorded, or so-called expenditures accorded to pension plans, are actually timing differences. They are not permanent differences. It is not a matter of whether or not you are going to get tax revenue, it is when you are going to get it, who is going to pay it and at what rate. If we look at it on a present value basis, I would say we would probably be making a lot different policy decisions than we have made in the past, and we need to.

Mr. RAMSTAD. Well, thank you, Mr. Walker. If you could provide that input, it would be appreciated.

And, again, thank you to all the witnesses.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Ford.

Mr. FORD. Thank you, Mr. Chairman.

Ms. Walker, I have a couple of questions for you. I think on H.R. 6, on page 8 of your testimony, you talked about the marriage penalty. You oppose the marriage penalty proposal in the Contract as being too complex, unworkable and bearing very little relationship to the magnitude of the marriage penalty in our current system. In your opinion, would the Contract proposal eliminate the marriage penalty for anyone?

Ms. DEBORAH WALKER. My understanding of how the marriage penalty would work that is in the proposal is that all taxpayers that were subject to the marriage penalty would somehow be put in a category and then we would divide up the $2 billion of tax expenditure and allocate it among those people.

So if that is the way it is intended to work, it would not eliminate it for anybody. It would eliminate a small piece for everybody subject to it.

The problem I see is really the complications in making this calculation, which, of course, the legislation does not outline how we would figure out how everybody is—what pieces they are subject to the marriage penalty, and then allocating the $2 billion.

Mr. FORD. Do you support the elimination of the marriage penalty completely?

Ms. DEBORAH WALKER. Completely. I support the elimination of the marriage penalty completely.

But I think there are ways to do it—and many States do this—is tax the two earners where you can choose married filing jointly or file as a single taxpayer and allocate your deductions and exemptions.

Mr. FORD. Which other part of the American dream proposal in this Contract would you replace with the approximately $14 billion a year for the marriage penalty, for this section to be removed. Is there any swap that you would like to see in the Contract that is before the committee?

Ms. DEBORAH WALKER. Well, that is probably an economic or social policy call.

Mr. FORD. You are a CPA. I am asking not you personally but from your industry.

Ms. DEBORAH WALKER. Within the American dream savings account—are you looking at the family tax credit? The American dream savings account and the elimination of the marriage penalty; and if we talk about the elimination of the marriage penalty, which other one would we support?

Mr. FORD. You could use it that way. Just stay within the American dream tax piece under this proposal with the Contract.

Ms. DEBORAH WALKER. That is a tough call.

Mr. FORD. That is a tough call.

You stated that the Contract's marriage penalty proposal would force all married couples to prepare as many as five Federal tax returns. Could you explain how this would happen?

Ms. DEBORAH WALKER. Well, married filing jointly, married filing separately, and two single returns, and it would be two married filing separately returns. And then, I think in the testimony I also pointed out that, of course, they would be calculating minimum tax and regular tax at the same time.

Now, with computers, that can all be done certainly more easily than it could have been done 10 or 15 years ago. But, notwithstanding, that we still do not like—I don't believe we like our taxpayers to think there are 10 different ways that you can pay your taxes and you get to figure out the cheapest.

Mr. FORD. But I am still—how much of the marriage penalty would the proposal alleviate for a typical taxpayer under this Contract's proposal?

Ms. DEBORAH WALKER. I believe in the ABA's testimony they computed it would be a credit of $91.

Mr. TERRY. It ends up, Mr. Ford, if you take the $2 billion and you apply it across the board—let us assume that half the people that file joint returns would get some benefit, should get some benefit. We calculate the annual amount to be $91. A total of $91 aftertax benefits. Not a very large amount in the overall picture.

Mr. FORD. But how does this compare with the amount of the average marriage penalty, Mr. Terry?

Mr. TERRY. It is considerably less, I would say, although we have not run the figures. I would say that that is substantially less than most of the—than the average would be. It is not a very large piece of the problem, put that way, for most taxpayers that have the problem.

Mr. FORD. And with the proposal in the Contract on the marriage penalty, the $2 billion would be thrown into the problem. Would you have a comment, as Ms. Walker might have said earlier, about the elimination of the marriage penalty?

Mr. TERRY. Mr. Ford, we do have a specific suggestion which—really, I guess we approach it this way. Since there is only a certain limited amount of money available to "throw at the problem," we would suggest that you approach it in a little bit different way and look strictly at the earnings.

The proposal, as drafted, suggests that you solve the marriage penalty with respect to all income, all earnings, both earned and unearned. We suggest that you focus on the earned income of the two married people and you apply a simpler credit to the earnings of the lower earning individual. This is very similar to a proposal, or something that was in the law several years ago.

We think that is simpler; that it does attack the problem, and it goes at it in a way that is understandable and administrable. So we do have a specific thought on this in the record.

Mr. FORD. My time is up; but, Ms. Walker, would you support that concept?

Ms. DEBORAH WALKER. Yes, we would. Because I think what people think is most unfair is the earnings tax as opposed to unearned income being taxed subject to the marriage penalty. On the other hand, if you really want it to be truly fair, you would take all income.

The one other thing I was going to add is I believe the Congressional Budget Office had statistics that said $16 billion is the annual marriage tax penalty. You could probably check that, but that would say that $2 to $16 billion is a very minuscule portion.

Mr. FORD. Thank you, Ms. Walker.

Chairman ARCHER. The gentleman's time has expired.
Mr. Hancock.
Mr. HANCOCK. Thank you, Mr. Chairman.
Mr. Porter, I was intrigued by your statement about capital gains and equity capital. Have you come to the conclusion that over the past 50 years that we maybe have overemphasized the real estate investment aspect of our economy?
Mr. PORTER. Well, I believe that we have—yes, that is my conclusion. It is really quite striking if you look at the allocation of the Nation's total pool of investable capital and where it actually goes. If you, again, correct for depreciation, more than half of it actually goes not for business real estate—I am not even counting that—but just for residential real estate.
Now, it is anybody's guess how to prove whether that is too much or too little—it is a very complicated calculation—but we know that it is not an accident. We know there is a whole array of subsidies for residential real estate. The biggest, of course, is the home mortgage deduction. The second biggest is the rollover of capital gains.
And I guess my suggestion is, if we are serious about long-term economic growth and creating jobs, it is probably time to start scaling those incentives back, starting with the people that are truly affluent people. And that is what my recommendations are addressed at.
Mr. HANCOCK. Basically, I think I am hearing you say that a $1 million home, after it is built, does not really add that much to the economy.
Mr. PORTER. Well, certainly somebody has to build it, and, temporarily, there will be some jobs created to build it. But, say, if you compare $1 million in investing in a home and $1 million in building a new plant to produce a new product, the return for the long term of the economy is really substantially greater in the plant.
Mr. HANCOCK. Is it also true that immediately following World War II a Harvard economist advised the Japanese to invest in economic production and the same economist advised the American people to build houses?
Mr. PORTER. Well, I cannot speak for that economist, because I know exactly who it is. But it is true that in our country, I believe, although it is very hard to do these calculations, we allocate a very large percentage of our investment budget to single-family housing and residential real estate.
Again, I do not want to come across as being against the American dream of owning your own home. I am talking about the size of these incentives and the degree to which they apply to really affluent people who perhaps do not need that kind of subsidy. And perhaps we should apply those resources to provide more incentives for investment in equity capital, in industry, if we are, again, serious about long-term economic growth.
Mr. HANCOCK. I have one other question I would like to ask the panel. As part of the Contract With America, we have the $500-per-child tax credit. The family tax credit, I fully support it, and I think every member of our side of this committee supports it.
However, I think we should take a real good look at it. Could that $117 billion be used to benefit more people, including the people that have a family? Like, for instance, a zero capital gains tax

rate on the first $2,500 of capital gains, or a zero tax on the first $1,000 of interest savings?

Could that be broadened to where it would benefit everybody rather than just people that happen to have children between the ages of 1 and 18?

Mr. PORTER. Well, again, I am not an expert in this area, but the general answer is yes.

In my testimony, I talk about the individual retirement account. And the concept there is that if you earn $30,000 a year it makes sense maybe to give somebody an incentive for the first dollar of savings in an IRA. But if you earn $100,000 a year, you should have to put $5,000 in your IRA before you receive any incentive.

And I think, again, if we could income meter these incentives, I think we could broaden their impact dramatically and actually increase net saving rather than just give a person a break on something they would already have set aside.

Mr. HANCOCK. Ms. Walker, I noticed when I mentioned the thousand dollars tax free in interest earnings, you nodded like that sounded like it might have some appeal.

Ms. DEBORAH WALKER. Well, I think you have to look at whether it is—you could do the same thing on a broader scale by taking the $500 credit and rolling it into the personal exemptions, and that does not limit it to children under age 13; or roll it into the standard deduction. In other words, increase the standard deduction and that would target, of course, families that claim the standard deduction and do not itemize their deductions.

The reason I smiled when you said the thousand dollars of interest exclusion is that that goes right to increasing savings, and that is what we——

Mr. HANCOCK. I think this hearing is designed to explore ways to encourage savings and investment. That is what why I brought it up.

Ms. DEBORAH WALKER. That is true, and that is why everybody here has said we need to encourage savings and investment. So perhaps an interest exclusion or a dividend exclusion, if we want to focus on equity instead of debt.

Mr. HANCOCK. Mr. Walker.

Mr. DAVID WALKER. Thank you, Mr. Hancock. I think it is very much appropriate to see how you can increase savings. But I think another element that needs to be focused on by the committee is, and I am sure you are, is how are you going to pay for this and what is the collateral effect going to be? There are only so many tax dollars available in order to provide incentives.

You also need to look at what is going to provide the greatest savings incentive and for whom. What level of income are those individuals going to be, both vertical and horizontal equity? And in that regard, I would suggest do not lose sight of employer-sponsored plans, because, generally, you get more horizontal and vertical equity in that than you do in some of the other individual savings arrangements.

Chairman ARCHER. The gentleman's time has expired.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Porter.

Mr. PORTER. I can answer one more. I have to chair a meeting this afternoon in Massachusetts.

Mr. ENGLISH. I will not detain you too long. It is delightful to have you here because I know you have done a lot of the seminal thinking on the factors that affect the competitive position of different countries.

And I wonder if you would generalize just briefly on the effect that the Tax Code has as it is structured right now on the competitive position of the American economy. And, specifically, what impact it has on certain sectors of the American economy. And here I have in mind manufacturing, which I believe is disproportionately affected by the Tax Code.

Is it fair to say—using an old term—that we have in place an industrial policy in this country in the Tax Code, which, in effect, puts some of our manufacturers at a competitive disadvantage? And would you recommend that this committee look at addressing that problem?

Mr. PORTER. Well, I certainly do. I have looked at a lot of economies around the world and have paid particular attention to the environment for investment in industry. This involves a complicated set of policies, but I think it is really quite striking how the United States is one of a group of countries that includes Great Britain and Canada and former British empire countries, all of whom are very low investors, chronically low investors. I think that is because all those countries share a certain number of similar characteristics.

They reward consumption and not investment. Almost every other major economy has very low or excluded long-term capital gains incentives. We also have a whole variety of other rules and regulations that actually work against emerging companies and high R&D companies. I do not have time and am not prepared to go through all of those, but I would be happy to submit to you a statement with some of the details.

But I think it is fair to say that we are working against our own economic interest with the tax structure we now have in place.

[The information is being retained in the committee files.]

Mr. ENGLISH. Is it fair to say that the tax structure that we have in America today, as it applies to manufacturing, puts American workers at a competitive disadvantage worldwide?

Mr. PORTER. I believe so. I think manufacturing is more capital-intensive, requires more investment in fixed capital, and often requires heavier formal R&D investments. To the extent that we are disincenting those kinds of investments, we are actually driving our own economy away from manufacturing and in other directions.

Mr. ENGLISH. Thank you. Obviously, this discussion could take up a lot of time, but I appreciate your making those basic points. We will look forward to hearing more from you.

I would personally be very interested in your findings on the subject and particularly on the importance of investment in inner cities. And I appreciate your presence here.

And, Mr. Chairman, I yield.

Mr. PORTER. Thank you.

Mr. BUNNING [presiding]. Mr. Gibbons.

Mr. GIBBONS. Mr. Walker, you mentioned the problems that the Social Security system and the Medicare system face and their long-term outlooks. One of the things that I had planned to do as chairman this year, which of course I am not, was to look at the Social Security financing. I have come to the conclusion that our problems are really easily repaired.

It seems the real problem in Social Security over the long term is our overindexing of benefits. If I understand the figures correctly, the benefits in the Social Security system will rise rapidly in the outyears; that we face prospects of a beneficiary having approximately three times as much purchasing power in the outyears as the beneficiaries do today; and that, therefore, we can solve that savings problem just by a simple readjustment of the indexing of benefits in the Social Security system.

I wonder have you looked at that and what your views are on that subject.

Mr. DAVID WALKER. Mr. Chairman—pardon me—Ranking Minority Member Gibbons, I know this is a topic that you have been very involved with for a number of years. My personal view is, with regard to Social Security—now I am speaking just of OASI, not Medicare, which is a different story.

Mr. GIBBONS. Yes.

Mr. DAVID WALKER. With regard to OASI, our latest projection is that the trust funds will run out of funds in 2036. That has come closer every year over the last several years. I believe that we can salvage Social Security. We must salvage Social Security. We need to take some steps sooner rather than later to do that.

I think one of the issues we have to look at, we have to look at indexing. We have to look at when benefits commence. We have to look at both the normal retirement age and early retirement age. We have to look at the factors that are used to reduce the early retirement benefit. I think we have to look at a variety of factors.

I think the bottom line is Social Security can, should and must be salvaged, but we have to act on it sooner rather than later. And it is going to be both revenue and benefit modifications that will get us there.

Mr. GIBBONS. I am sorry Mr. Porter had to leave, but perhaps some of the rest of the panel will have some views on this. There seems to be no doubt in the consensus of the opinion of economists and others in our society that we have overstimulated investment in real property, and it is my hunch that most of it has ended up really in inflated values in real property. By our overstimulation we have just increased investment in that area; therefore, increased the price and made it no easier, really, for low-income people to get started in a house.

One of the biggest stimulations is the home mortgage interest deduction. I notice in Canada, right next to us, that has a good stock of housing, it has no home mortgage interest deduction. I don't propose to do away with the home mortgage interest deduction, but, in your opinion, should we limit the home mortgage interest deduction?

Any of you want to take a shot at it?

Mr. TERRY. Mr. Gibbons, I will respond indirectly to that. It is interesting, but the interest deduction, which used to be a fairly simple provision in the Internal Revenue Code, is now viciously complex, particularly the investment interest limitations, even the mortgage deduction interest, which is so important to so many low- and medium-income people.

One of the things I think this committee could do very productively would be to try to simplify that thing so that the people—and these are the run of the mill taxpayers that have these kinds of deductions, primarily—and I think one thing that would help considerably would be to simplify the mortgage interest deduction across the board. I think there are ways to do that.

Mr. GIBBONS. Well, I guess I lost my principal witness, Mr. Porter, when he had to leave, so I will suspend my questions here. Thank you.

Mr. BUNNING. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I actually wanted to address some of this questioning to Mr. Porter, but maybe, Ms. Walker, if we could get your perspective on it. It has to do with the idea of encouraging investment in low-income areas such as inner cities.

I have been doing some research into that as well, in trying to come up with ways maybe to zero capital gains taxes in inner cities, possibly raising the expensing provision for capital equipment up to $100,000 to $200,000, items such as those, and in that process have run across some questions.

Some people have explored these in the past. They have talked about the problem being that people take older assets, move them into those areas strictly for the tax advantages instead of investing new capital. Could you just address some of the issues, if you have looked into this area.

Ms. DEBORAH WALKER. Well, I have not looked at this area significantly.

And I guess the other thing that comes to mind—I will speak to yours in 1 minute—but the other thing that comes to mind is defining what are those areas, and I think that might be more complex.

Mr. ENSIGN. Well, I think the administration recently has designated empowerment zones and enterprise zones. Areas such as those would be pretty easy to piggyback on top of.

Ms. DEBORAH WALKER. There are rules, antichurning rules, that are in the depreciation rules. And those rules you could piggyback off of to avoid what you are talking about, which is selling to a related party in order to qualify for the credit or the deduction.

Mr. ENSIGN. OK. Obviously, we are dealing with welfare reform on this committee as well. One of the reasons that I have such an intense interest in this, is that the complaints we hear are that there are no jobs in the inner cities, there are no jobs for these people that we are trying to get into workfare-type programs.

What is your feeling? Do you think this will increase incentives to generate jobs there? Do you think businesses will take the incentives in these areas? Are the financial incentives great enough to overcome the security problems, the various other local issues that you deal with?

Ms. DEBORAH WALKER. In dealing with clients, that is going to be just a purely individual client decision. But there are going to have to be significant incentives to overcome the risk that you talk about and the aggravation.

Mr. ENSIGN. Mr. Walker.

Mr. DAVID WALKER. I would say, Mr. Ensign, that, in general, I think that there is an increase in corporate social responsibility in this country. And I think more and more corporations and other business enterprises are recognizing that it is our problem, and there is a lot more volunteerism and activism that is happening.

And you are right, there is a tradeoff between the economic tax incentives and the other considerations, but I think more people are recognizing we have to deal with these issues, and they are part of the solution in trying to do that.

Mr. ENSIGN. Thank you, Mr. Chairman.

Mr. BUNNING. Mr. Zimmer will inquire. He is not here.

Mr. Houghton.

Mr. HOUGHTON. No questions.

Mr. BUNNING. Mr. Levin.

Mr. LEVIN. Thank you.

Like others, I was sorry that Professor Porter had to leave because his suggestion would be quite different than what is in the Contract, and I think it would be worthy of our having some discussion of it, excluding all investments other than equity investments and making it prospective only. That is really quite a different proposal, both in what is covered and also in its fiscal implications.

But let me just ask the three of you, whoever would like to comment, about the implications of capital gains proposals in the Contract and otherwise for tax shelters. What concerns do you have about their recurrence?

Mr. TERRY. Mr. Levin, analyzing the provisions in the Contract, one of the things that we point out with respect to the 50-percent capital gains deduction, we do think that will lead to increased tax planning.

You know, tax lawyers are called upon to figure out ways to achieve capital gains, and it results in attention by tax lawyers in figuring a way to convert ordinary income into capital gains. And although that is not traditionally referred to as a tax shelter in the same sense that in the eighties, late seventies you had these fancy deals that were marketed, nevertheless, that does—and we indicate in our statement—that does present some concerns. We think it will increase transactional complexity, and we think it is something that should be taken into account by the committee.

Mr. LEVIN. Anybody else? Yes, Ms. Walker.

Ms. DEBORAH WALKER. In my testimony I give an example of how the lack of indexing the debt can increase the rate of return.

Basically, if you assume that somebody buys stock for $1,000 and purchases that with a loan, and the loan pays 8 percent interest and inflation is 5 percent. So the interest rate is a little higher than inflation. And now let us assume 1 year later the property has appreciated 10 percent. So we have earned $100 on our thousand dollars' worth of stock. That is a 10 percent before-tax rate of return. With the 50-percent capital gains deduction, it is really an 8 percent aftertax rate of return, assuming a 40 percent tax rate—39.6.

So, if we index that gain—remember, I said we were going to assume it appreciated 10 percent, but half of that is going to be inflation. So if we index that gain, now we have a 9 percent aftertax rate of return instead of the 10 percent that you would have just with the capital gains—or instead of the 8 percent you would with the capital gains exclusion.

And you get to the negative rate of return by the fact that we get to deduct the $80 interest against ordinary income rates. By deducting the interest that we paid on this $1,000 investment, we have increased our rate of return to 12.2 percent when an asset only earned 10 percent before tax.

It is really the interplay of the interest expense deduction and the capital gains exclusion and the indexing that gets you a negative tax rate.

Mr. LEVIN. This has been the dynamic problem all along, and it was presumably diminished and now may be increased.

Ms. DEBORAH WALKER. That is true.

Mr. LEVIN. I think we have to look at it.

One other thing. As I understand it, there was some testimony about IRAs suggesting that they not apply to rollovers. Does anyone wants to expand on that?

Mr. TERRY. Mr. Levin, we addressed that in our written statement. I think the primary focus of our comments, that there is nothing in the IRA proposal which would, in the case of the rollover, that would eliminate the possibility of someone rolling amounts from—large amounts—from qualified plans within this little window period, couple-year window period, that is provided for the new super savings accounts. The new IRAs.

And, having those amounts, they are taxed as they go in; but then, under usual rules, there is an obligation that you make distributions of that and put it back into the income stream promptly. The provisions in this bill, as currently drafted, do not require that kind of distribution, that kind of withdrawal. And we think that could be a problem.

Other than that—and that is primarily a technical problem, and I think it particularly applies after death. The way it now reads you could continue these amounts on for generations without having them ever come out of the account. That, I think, is extreme.

So those are our thoughts on the rollover problem.

Mr. LEVIN. My time is up. Thank you.

Mr. BUNNING. We want to thank the panel for their testimony, and we would invite the second panel to—the third panel, actually—to move forward.

Mr. Forsythe, Ms. Obermayer, Don Strong, Tom Diedrich, Steven Cohen, and Henry Davis.

And the gentleman from Minnesota, I yield to him for an introduction of two of the members of this panel.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Mr. Chairman, it is a pleasure to welcome this panel, particularly, as you mentioned, two of the witnesses are from Minnesota, John Forsythe and Tom Diedrich. Jack, to those of us who know him well, Forsythe is vice president for tax and public affairs of Ecolab in St. Paul and is testifying on behalf of Ecolab's sales force employees. Welcome, Jack.

And Tom Diedrich, who is also a constituent—in fact, from my hometown of Minnetonka, Minn.—is here on behalf of the Bureau of Wholesale Sales Representatives. Mr. Diedrich is president of The Diedrich Group of Minnetonka.

So welcome to the panel, particularly to my good friends from Minnesota. I look forward to your testimony.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA
February 1, 1995

Mr. Chairman, it is a pleasure to welcome this panels -- particularly since two of the witnesses are from Minnesota: John Forsythe and Tom Diedrich.

Mr. Forsythe is Vice President for Tax and Public Affairs of Ecolab, St. Paul, MN, and is testifying on behalf of Ecolab's Sales Force Employees.

Mr. Diedrich of the Diedrich Group, Minnetonka, MN, is here on behalf of the Bureau of Wholesale Representatives.

I am very pleased we have two witnesses from Minnesota who know how much this tax relief will help the self-employed and other workers who conduct their business at home.

Clarifying the home office deduction would make a major difference to thousands of small businesses in the Third Congressional District and throughout Minnesota and the country. The home office deduction provision is one of several initiatives in the Contract with America that recognizes the important contribution small businesses make in our economy. Small businesses create over 80 percent of the new jobs in America.

The home office deduction provision is on the cutting-edge of job trends as more Americans choose to "tele-commute" by computer or utilize other methods to work at home. We should especially help parents with young children who want to spend more of their working hours at home.

The Contract With America's Job Creation and Wage Enhancement Act includes a provision allowing taxpayers to qualify for the home-office deduction if the home-office is (1) used exclusively for business purposes, (2) used on a regular basis, (3) used to perform tasks that could not easily be performed elsewhere and (4) is essential to the taxpayer's business.

Mr. Chairman, thank you again for assembling such an excellent panel. I look forward to hearing from all of our witnesses today.

Mr. BUNNING. I want to advise you that we are under the 5-minute rule, and if you would condense your written statements they will be entered into the record.

And, Mr. Forsythe, you may begin.

STATEMENT OF JOHN G. FORSYTHE, VICE PRESIDENT, TAX AND PUBLIC AFFAIRS, ECOLAB, INC., ST. PAUL, MINN., ON BEHALF OF ECOLAB'S SALES FORCE EMPLOYEES; ACCOMPANIED BY DICK LANE

Mr. FORSYTHE. Thank you, Mr. Chairman and members of the committee and particularly Mr. Ramstad. Thank you in particular for the invitation to be here with you today to discuss the home office deduction.

I am accompanied by Dick Lane here on my left, an employee in our sales force who maintains a home office to perform his job for Ecolab.

Ecolab is the leading developer and marketer——

Mr. BUNNING. Mr. Forsythe, would you please move the mike a little closer?

Mr. FORSYTHE. Yes, thank you.

Ecolab is the leading developer and marketer of premium cleaning, sanitizing and maintenance products and services for the hospitality, institutional and industrial markets. That means we make soap and detergents. Our customers include hotels, restaurants, food service and health care facilities, dairy plants and food and beverage processors around the world.

Founded in 1924, Ecolab is a $1 billion sales Fortune 500 company based in St. Paul, Minn., and we operate in all 50 States. We employ 7,500 people. The home office deduction has no impact on the tax liability of Ecolab, but it is a serious tax problem for many of our employees.

On behalf of approximately 2,000 of those entrepreneurial employees who work out of their homes selling our products to local restaurants and other businesses, I applaud the provision in the Contract With America which would clarify that more of our employees can deduct the cost of maintaining a business office in their home, and we applaud the fact that this issue is one of your first 100-day agenda items.

At Ecolab, we serve our customers through a sales and service network of territory managers, many of whom, like Dick, travel great distances between calls. In their home offices, Ecolab's territory managers store inventory, assemble equipment, perform 7 to 10 hours of administrative work each week and return customer phone calls.

My written remarks include a more detailed description of the problem with the current law. But, fundamentally, the problem is many taxpayers now need professional tax advice to determine whether they are entitled to a tax deduction for the home office. And certain groups of employees, who spend most of their time on the road and with customers, are inherently disadvantaged under the Internal Revenue Code and the standards that are set forth in the *Soliman* case.

The Job Creation and Wage Enhancement Act would amend the code to allow a home office to qualify for a deduction as the principal place of business if it is where the taxpayer regularly and systematically conducts essential administrative and management activities and the taxpayer has no other location to perform those activities. The provision retains the current law requirement that the office be used exclusively for business and the convenience of the employer.

At Ecolab, we support the proposed changes for the following reasons:

First, it promotes a better balance between business considerations and family needs for those who can meet the revised standard of deductibility. Our people are on 24-hour call.

Second, it is consistent with the new technological advances that make it more common and efficient for many types of employees to work out of their homes.

And, finally, there is a fairness issue here. When customers come to your home office you get to take the deduction. When you have to provide services onsite, as is the case with our sales personnel, you do not.

One other thing. It is a significant simplification of the Internal Revenue Code, and that will greatly ameliorate a needless area of controversy between the taxpayers and the IRS.

Most of our sales force spend the majority of their time serving customers at the customers' place of business. Important business activities like matching our products with our customers' needs are conducted at the customers' place of business. The place where the preparation, administrative and management activities are performed are generally done in the home office, and the home office should be treated as a deductible place of business for tax purposes, especially when there is no other office available.

For the Ecolab sales force, home offices are the most efficient and cost effective way to create productive and high-paying sales jobs. Commuting to a separate place of business to perform essential administrative and management functions simply is not practical nor necessary from a business point of view. The tax law should not encourage or demand practices that do not make sense from a business perspective.

The legislation proposed before the committee makes sense, and Ecolab supports it. Thank you. Both Dick and I will be happy to respond to questions.

[The prepared statement follows:]

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John G. Forsythe
Vice President - Tax and Public Affairs

Statement on "Contract With America"

John G. Forsythe
Vice President of Tax and Public Affairs,
Ecolab Inc.

Before the

Committee on Ways and Means

February 1, 1995

Mr. Chairman and Members of the Committee, I appreciate your invitation to be here today and discuss the home office deduction. I am accompanied by Dick Lane, an employee in our sales force who maintains a home office in South Dakota to perform his job for Ecolab. Ecolab is the leading developer and marketer of premium cleaning, sanitizing, and maintenance products and services for hospitality, institutional and industrial markets. Our customers include hotels and restaurants, foodservice and health care facilities, dairy plants, and food and beverage processors around the world. Founded in 1924, Ecolab is a $1 billion Fortune 500 company based in St. Paul, Minnesota and operating in all 50 states. We employ 7,500 people. The home office deduction has no impact on the tax liability of Ecolab, but rather is a serious tax problem for many of our employees.

On behalf of our approximately 2,000 entrepreneurial employees who work out of their homes selling our products to local restaurants and other businesses, I applaud the provision in the "Contract with America" which would clarify that more of our employees can deduct the costs of maintaining a business office in their home, and the fact that the issue is one of your first 100-day agenda items. At Ecolab, we serve our customers through a sales and service network of Territory Managers, many of whom travel great distances between calls. In their home offices, Ecolab's Territory Managers store inventory, assemble equipment, perform seven to ten hours of administrative work each week, and return customer phone calls.

The Job Creation and Wage Enhancement Act (H.R. 9) would amend IRC section 280A, to allow a home office to qualify for a deduction as the "principal place of business" if it is where the taxpayer regularly and systematically conducts essential administrative and management activities and the taxpayer has no other location to perform these activities for the business. The provision retains the current law requirement that the office be used exclusively for business and for the convenience of the employer. We support the proposed change for the following reasons:

- It promotes a better balance between business considerations and family needs for those who can meet the revised standard of deductibility.
- It is consistent with technological advancements that make it more common and efficient for many types of employees to work out of their homes.

- It provides a fairer rule for those whose employers maintain no local business office and who maintain a business office in their homes for essential business activities.

- It substantially eliminates the arbitrary preference shown for some businesses which can deduct the cost of operating a business office out of a personal residence because customers are served there, while other types of businesses which require the taxpayer to spend significant periods of time working outside of the home are denied the deduction for an equally essential home office.

- It is a significant simplification of the Internal Revenue Code that will greatly ameliorate a needless area of controversy between taxpayers and the IRS.

The Tax Reform Act of 1976 added the long-standing rule in IRC Section 280A(c)(1), which provides that the "portion of the dwelling unit which is exclusively used on a regular basis ... [as] the principal place of business ... of the taxpayer" (emphasis added) is exempted from the general rule that prohibits a business expense deduction for a portion of the cost of a personal residence. However subsequent judicial activity has imposed severe restrictions on the ability of taxpayers to make use of this provision. In the 1993 case of Commissioner of Internal Revenue v. Soliman, the U.S. Supreme Court reversed earlier decisions of the Tax Court and the Fourth Circuit Court of Appeals and established new guidelines for home offices to qualify as a "principal place of business." Currently, it is not sufficient to show that the activities performed in the home office are essential to the business; rather it must be established that the functions performed in the home are the most significant events relative to the business in question. Taxpayers must consider the relative importance of activities performed at each business location and focus on whether revenue is generated or services are performed in their home offices. The court further held that taxpayers should compare the amount of time spent at home with time spent at other places where business activities occur. The Court noted that this comparative analysis may reveal that no principal place of business exists, as it does not demonstrate that the principal place of business is the taxpayer's home - in which case - the taxpayer is not entitled to a deduction for the home office.

The result is that many taxpayers now need professional tax advice to determine whether they are entitled to a tax deduction for a home office, and certain groups of employees who spend most of their time on the road and with customers are inherently disadvantaged under the IRC section 280A rules and the standards set forth in Soliman.

In the Soliman case, the taxpayer was an anesthesiologist. The Court noted that the taxpayer spent 10 - 15 hours of essential administrative and preparation time in his home office as compared to 30 to 35 hours performing services in three hospitals. In Soliman, the Court stated that if the nature of the business "requires the taxpayer to meet or conference with a client ... or to deliver goods or services to a customer, the place where that contact occurs is often an important indicator of the principal place of business." Since Soliman met no patients at home, no deduction was allowed. Our employees face a similar fact pattern. Ecolab's sales force is comprised of people who similarly perform essential business activities in their home, but rightly spend significant time with customers in the field, matching our products with our customers' needs. It is doubtful that many of our employees can demonstrate that they are entitled to deduct the cost of their home offices under the Supreme Court's overly strict standards in Soliman. Many will feel they need professional advice to make this determination. This is unfortunate because, as described earlier, our sales force generally has no place of business, other than their offices at home, in which to perform essential administrative and management activities. The kinds of business expenses disallowed include a portion of the cost of utilities, insurance, home repairs, security systems, and depreciation, and business mileage incurred in earning their livings.

The holding in Soliman allows the nature of the taxpayer's business to dictate whether the taxpayer's home office is deductible. Some types of businesses clearly have principal places of businesses; others do not. If the taxpayer is a dentist that uses the home office to treat patients, it is deductible. If the taxpayer is in a service business that performs the actual service or selling functions at the customer's job site, then the use of the home office, and equipment therein, for essential management and planning functions, is not deductible. This is an unfair and artificial distinction.

Most of our sales force spend the majority of their time serving customers at the customers' place of business. Many of the important business activities, like matching our products with our customers' needs, are conducted at the customers' place of business. The place where the preparation, administrative and management activities are performed is generally a home office, and it should be treated as the principal place of business for tax purposes where there is no other office available. Commuting to a separate place of business to perform essential administrative and management functions simply is not practical nor necessary from a business point of view. The tax law should not encourage, or demand, practices that do not make sense from a business perspective. For the Ecolab sales force, home offices are the most efficient and cost-effective way to create productive and high paying sales jobs.

Congress needs to take the first real step in ensuring equitable tax treatment for people working out of their homes by statutorily providing for the home office deduction in cases where the taxpayers would have been permitted to deduct the same expenses if they had rented office space. The legislative proposal before the committee would define principal place of business to include offices where management activities essential to the conduct of the business are performed on a systematic basis and where the office is necessary because the taxpayer has no other location for the performance of these activities. Ecolab strongly supports legislation to this effect. It would reduce the inequities in the current rules and adjust the tax code to comport better with the growing trend of employees working out of their homes.

Mr. BUNNING. Thank you.

Dr. Obermayer.

STATEMENT OF JUDITH OBERMAYER, PH.D., CHAIRMAN, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED, WASHINGTON, D.C., AND OWNER, OBERMAYER ASSOCIATES, WEST NEWTON, MASS.

Ms. OBERMAYER. Thank you, Mr. Chairman, members of the committee. Thank you for inviting me to testify today.

I am Judith Obermayer, owner of Obermayer Associates, a home-based business in Newton, Mass. I am testifying as chairman of the board of the National Association for the Self-Employed, and my testimony has been endorsed by the Massachusetts delegation to the White House Conference on Small Business, which I chair.

I am testifying also in favor of the home office provisions of H.R. 9, which seek to negate a recent Supreme Court decision which severely restricts the ability of many home-based businesses to take any deduction for home office expenses.

Basically, the court ruled that customers must physically come to the office and that business income must be generated within the home office itself, not from transactions outside. The decision effectively treats the administrative activities of the business—recordkeeping, bookkeeping, regulatory compliance—as unimportant.

There are a large number of people affected by this change in the rule. You just heard about one set of people. Independent sales representatives of all kinds are affected. But so are electricians and contractors and consultants all over the country.

There are a huge number of people affected by this change. If you look at tax returns, 12.2 million people indicate that they are self-employed. We believe that several million of those people are home-based. Within our own organization of 320,000 people, most of whom have businesses of 5 or fewer employees, we estimate 65 percent are home-based businesses. And, in most cases, we are talking about very small businesses, where the deduction in question is not that large but it can be very important to a small, struggling business.

Actually, there has been a trend toward home-based business generally in the economy. The nature of business has changed today. We have been affected by competitive forces, technological changes that both allow us to do business almost anywhere with a computer and a modem and a fax machine and a cellular telephone. Any place is an office in terms of being able to do things. People have changed the way they do things.

There has also been a move toward the information- and service-based economy, which also goes along with this whole trend. And there is also a factor that has to do with people being concerned about balancing work and family, especially in dual-income and single-parent families. For many of them, home-based business is a very important option.

In my State of Massachusetts, we had the "Massachusetts Miracle" of the eighties—followed, unfortunately, by the recession of the nineties. We saw the restructuring of the computer industry, the collapse of the real estate industry, cutbacks in defense, and competition from abroad. All of those forces brought us to the point of reengineering and downsizing throughout the economy. And the industries hit were not just things like the computer industry but the financial services industry and, even now, the health insurance industry.

What happens to all those tens of thousands of people who are laid off? For many of them, it is very difficult. If you are over 50 and laid off from a job your chances of getting full-time employment are really very small. Even when the economy picks up again, these people have often been replaced by younger, cheaper workers. One of their most viable options is to look at the process of starting a business for themselves.

And that is also true of anybody who has any kind of professional, business, marketable skills. It is also true of people who have technical ideas who now might take the opportunity to start a new business. And almost always when these businesses started they are home-based. You do not have to put in a very big investment to do a home-based business. A few pieces of office equipment or lab equipment and you can go ahead.

We really should be encouraging this kind of trend. These are the businesses we hope ultimately will grow, and many of them will move out of the home, we hope. But that is where the best place is for them to start, and we should be doing things to encourage them. We should not be putting impediments in the way of people trying to do this kind of thing.

In conclusion, I would like to say that the National Association for the Self-Employed strongly supports the home office deduction provisions of H.R. 9. We have also been joined by nearly 40 associations with over 2 million members in this effort.

We look forward to working with House Ways and Means to ensure enactment of this important provision for small business. Thank you very much.

[The prepared statement follows:]

TESTIMONY OF JUDITH OBERMAYER
NATIONAL ASSOCIATION FOR THE SELF EMPLOYED

Chairman Bill Archer, Ranking Member Sam Gibbons, and House Ways and Means Committee members, thank you for inviting me to testify today. My name is Judith Obermayer, owner of Obermayer Associates, a home-based business located in West Newton, Massachusetts. I am here to testify today as Chairman of the Board of Directors for the National Association for the Self-Employed. It is with pleasure that I inform you that my testimony has been endorsed by the Massachusetts delegation to the June 1995 White House Conference on Small Business, a delegation of small business owners which I chair.

As the operator of a home-based business, I provide financial and management consulting services to high technology companies. My firm helps these companies develop business plans and strategies for raising money to fund business expansion. Of significance, many of these high technology companies started out as home-based businesses.

On behalf of the NASE, I am pleased to testify on the home office tax deduction. The NASE represents over 320,000 small business persons from throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership is involved with a very wide range of businesses, notably in the consulting and retail fields. The home office deduction is extremely important to the NASE. We project, based on a recent survey, that about 65 percent of our members operate home-based businesses.

Home-Based Businesses In the 1990s

The U.S economy changed during the nineteenth and twentieth centuries from an agricultural to a manufacturing-based economy, and is now moving rapidly to a service and information-based economy. The factory and commercial office buildings of only 10 or 20 years ago are rapidly declining in importance as companies re-engineer their work places and tap into the desires of the work force to use modern telecommunications tools to work where it is most convenient. Often that means working at home. The recession both accelerated these trends and provided a means for workers to go it alone, if necessary, through the operation of home-based businesses.

Everyone is familiar with the phrase "Massachusetts Miracle", which was used to refer to the business climate in my state of Massachusetts prior to the 1989-1992 recession. In the middle to late 1980's, my state was booming economically. Computer companies, such as Digital, Prime, and Wang Corporations, were selling high technology products throughout the United States; and as a result, were hiring thousands of new workers to fill office and factory buildings along Boston's famed Route 128 corridor. Real estate, and banking and financial institutions -- like Fidelity Investments -- were booming as well in the 1980's.

By 1989 the Massachusetts Miracle was no more. The recession resulted in the layoff of tens of thousands of workers in my state. The downsizing of Massachusetts's computer companies and financial institutions involved the layoff of blue-collar individuals -- and highly skilled persons such as engineers, marketing and sales representatives. Unemployment for these people often meant that starting a home-based business was their only option for finding a "job."

In testifying about home-based businesses today, the NASE is calling on Congress to overturn a 1993 U.S. Supreme Court decision (described in greater detail below) which dramatically cut back on the availability of the home office tax deduction. The home office deduction is not a tax incentive for the wealthy. It is a deduction important to (among others) consultants of all types, private nurses, independent sales representatives, plumbers, and persons in the construction trades. With the development of new technologies (such as facsimile machines, modems, personal computers, etc.) home-based businesses have become extremely popular because they make sense to the work force of the 1990s.

According to a 1994 survey by the LINK Resources Corporation, over 43 million people now do some portion of their work at home, a figure which includes self-employed persons, telecommuters, and individuals with employee status. Based on the number of 1992 tax returns reporting the payment of federal self-employment tax, there are about 12.2 million self-employed individuals in the United States. We believe several million of these persons operate home-based businesses.

By fostering home-based businesses, Congress would be taking steps to increase productivity and spur economic growth. Home offices are popular in the 1990's because they make sense for businesses, families, and individuals.

H.R. 9, the Job Creation and Wage Enhancement Act of 1995

The NASE strongly supports the home office deduction provisions of H.R. 9, the Job Creation and Wage Enhancement Act. These provisions provide much needed clarification to the small business community regarding the availability of the home office deduction. We want to thank Chairman Archer for introducing H.R. 9, and others members of the House Ways and Means Committee for being original cosponsors of the bill. Among other objectives, the legislation provides for reform of the home office tax deduction in light of the 1993 U.S. Supreme Court decision in the *IRS Commissioner v. Soliman* case. This case substantially narrowed the availability of the home office deduction to America's small business community.

Home office deduction reform enjoys broad-based bipartisan support. The NASE commends Representative Nancy Johnson for her introduction of a home office deduction reform measure in the last Congress. Moreover, numerous Republican and Democratic members of the Ways and Means Committee joined Representative Johnson in this effort in 1993 and 1994. We applaud their efforts.

In the aftermath of the 1993 *Soliman* case -- tens of thousands of owners of home-based businesses found themselves disenfranchised from taking a legitimate business deduction on their tax return. For this reason, within weeks of the public release of this 1993 Supreme Court decision, the NASE began building a coalition of associations supporting legislation to overturn the court decision. Nearly forty associations have joined the NASE in this effort, a coalition representing over 2 million businesses in the United States..

The IRS Commissioner v. Soliman Decision

In order to be eligible for a home office deduction under Internal Revenue Code Section 280A(c), the business owner must use the office on an exclusive and regular use basis, and the office must either be (a) his principal place of business; (b) the place where he meets or deals with patients, clients, or customers in the normal course of his trade or business; or (c) a separate structure which is not attached to the dwelling unit. Moreover, a person claiming a home office deduction may not claim a deduction for more than the revenues of the business (in other words, a $100 deduction can not be claimed when business revenues amount to only $50).

The *Soliman* decision revolves around the definition of "principal place of business." Under this U.S. Supreme Court holding, an anesthesiologist was found not to be entitled to a home office deduction because the doctor's principal place of business was determined by the court to be the hospitals where the doctor performed services for patients. The court ruled in this fashion even though the anesthesiologist saw patients in several hospitals, none of which provided him with an office. The doctor contacted patients, set up appointments, did billings, and kept his business records at the home office.

The U.S. Tax Court and the U.S. Ninth Circuit Court of Appeals ruled in favor of the doctor. Seeking to overturn the pro-taxpayer decisions of the lower courts, the IRS appealed the *Soliman* case to the U.S. Supreme Court. It was a surprise to many people that the Supreme Court ultimately reversed the lower court decisions in favor of the IRS by disallowing Soliman's home office deduction.

Mr. Leslie B. Samuels, Assistant Treasury Secretary for Tax Policy, testified before the House Ways and Means Committee on January 10, 1995 regarding the home office deduction and other provisions contained in the Contract With America. In describing the *Soliman* decision, Mr Samuels stated, "[T]he Supreme Court held that the principal place of business should be defined to include only the place of business where the activities most crucial to the operation of the business occur...For example, activities crucial to certain service businesses require personal contact with customers outside the service provider's home office. In such cases, the home office would not be regarded as the principal place of business, even if no other principal place of business existed."

In effect, the Supreme Court seems to be requiring two new tests in order for an individual to qualify for the deduction. The court decision effectively requires (1) the customers of a home business to physically visit the home office and (2) that the business income be generated within the home office itself -- not from transactions that occur outside the home office.

The NASE firmly believes the holding in the *Soliman* case to be extremely shortsighted -- especially since the decision ignores the way business is conducted today. Offices have changed dramatically in the last twenty years. That is, personal computers, facsimile machines, computer networks, and overnight delivery services have made it unnecessary to bring customers through the home office. The holding is also shortsighted as local zoning ordinances often prohibit home-based businesses from bringing customers to the home office.

The *Soliman* decision creates significant problems for a broad range of industries and professions. The list of people potentially losing the deduction includes independent sales representatives, plumbers, electricians, remodeling specialists, home builders, veterinarians, travel agents, and others. Now, as a result of *Soliman*, these business persons must effectively bring their customers through the home office in order to qualify for the deduction.

<u>The Recordkeeping and Bookkeeping Functions of the Business</u>

By holding that the home office must itself generate revenue, the *Soliman* decision effectively treats the administrative activities of the business as unimportant. That is, the *Soliman* holding serves to minimize the importance of the recordkeeping and bookkeeping functions of the business, as well as its tax and regulatory compliance activities. Ironically, it is the government itself, notably the IRS, which generates the demand for many of these activities.

This problem is clearly addressed under Section 12003 of (H.R. 9) the Job Creation and Wage Enhancement Act. The entrepreneur's home office would qualify under the Act as a principal place of business (and thus, be eligible for the home office deduction) if: (A) the taxpayer conducts his essential administrative or management activities at the home office; (B) such activities are conducted at the home office on a regular and systematic basis; and (C) the home office is the only office utilized by the business person.

H.R. 9 shows an appreciation for the conveniences home-based businesses offer American families. A home-based business provides a spouse (including a single parent) the emotional benefits of taking care of his or her children at home while earning money at the same time. In addition, as described above, the measure is an excellent response to the current spate of corporate downsizings which have resulted in the layoffs of tens of thousands of workers. They, like many other people, are now attempting to live the American dream by starting businesses out of their homes.

<u>Storage of Product Samples</u>

Internal Revenue Code Section 280A(c)(2) permits an independent sales representative and others to generally take a home office deduction for the space used on a regular basis in the home with respect to a storage unit of inventory held for resale. This sales person is eligible for the home office deduction -- under the Code provision -- as long as the dwelling unit is the only location of his trade or business.

Section 12004 of H.R. 9 modifies Code Section 280A(c)(2) by expanding the definition of a storage unit to include a place where product samples may be stored. The NASE views Section 12004 as a positive measure for small business. We believe the measure will contribute to economic growth by fostering the sale of products at the retail and wholesale levels.

In conclusion, the NASE strongly supports the home office deduction provisions of H.R. 9. We look forward to working with the House Ways and Means Committee to ensure enactment of these important provisions for small business.

Mr. BUNNING. Thank you, Dr. Obermayer.
Mr. Strong.

STATEMENT OF DON STRONG, PRINCIPAL OWNER, BROTHERS STRONG, INC., HOUSTON, TEX., ON BEHALF OF THE NATIONAL ASSOCIATION OF THE REMODELING INDUSTRY, ARLINGTON, VA.

Mr. STRONG. Mr. Chairman, honorable members of the committee, I am honored to provide testimony in support of the proposed restoration of the home office deduction.

My name is Don Strong, and I am principal owner of Brothers Strong, Inc., a small remodeling firm specializing in residential remodeling. Brothers Strong operates out of a separate suite of offices located in my home. I currently have five full-time employees and six subcontractors. Two employees spend all day in the office, and I spend about one-third of my life in that office.

I am also a member of the Houston chapter of the National Association of the Remodeling Industry. NARI is a not-for-profit trade organization with nearly 6,000 member companies nationwide and represents 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors and include national manufacturers and distributors of home improvement products and services.

Residential remodeling constitutes a $100 billion industry and has grown 130 percent in the last 10 years. In fact, we are close to surpassing new home construction in total dollars contributed to the economy.

I appear today in complete support of efforts made by you, Mr. Chairman, this committee and others, to restore the home office deduction provisions that were significantly reduced by the U.S. Supreme Court ruling, *Commissioner of the IRS* v. *Nader Soliman* in January 1993.

The Court's ruling put a severe crimp in the ability of small businessowners like myself to further grow their home-based and/or startup businesses. Before the Court's ruling, I could deduct a reasonable portion of my home office expenses, just as other businesses can if they operate in another location. I simply prefer to keep my business in my home. I think it is unfair having lost this deduction.

The Court's ruling added two new eligibility tests that remodelers simply cannot meet. First, the Court and the law now require that businessowners must have customers come to their home office. In service-based businesses, such as residential remodeling, it is I who must travel to the customer's home to discuss possible home improvement projects. I need to see what their project consists of, its location, size, and scope. It is inconceivable for a remodeler to develop a remodeling project site unseen.

Second, the law now requires that business income must be generated within the home office, not from transactions that occur outside the home office. Again, it is impossible for a remodeler to remodel a home from his home office. The income-generating activities are conducted at the client's home.

So if I am selling jobs in the community and doing the remodeling on location, what is it I do that makes the home office so important, the IRS might ask. Why do I deserve this deduction?

I use my home office to perform all the activities that any remodeler needs to do to effectively run his or her business. I prepare estimates, contracts, plans and marketing materials. I develop leads, make the business phone calls, organize business materials and deliveries, solicit subcontractor bids and research industry trends. I record all business transactions, receipts, and expenses. I maintain all relevant regulatory information and, most importantly, the IRS recordkeeping. This is where I pay my bills, and this is where I contribute to the U.S. Treasury.

In my home office, I have three separate phone lines, a fax machine, three computers, a printer, a small copying machine—everything an office needs to conduct business. If I prefer to rent an outside space, my entire overhead would be deductible without question. But because I choose to remain at home, I can no longer deduct those real expenses. But I have no need for outside space. My business has grown to a comfortable level working at home.

Please allow me to speak for my fellow remodelers. Since remodeling is not a high-profit business, you have to love it to get into it and sweat it to stay in it. The mortality rate is extremely high. What I am saying is we need every break we can get not only to survive but to continue to grow and to help the economy.

I am at the point where I would like to hire another production manager, but I am hesitant. With the recent reduction in business deductions contained in the 1993 budget, and this Supreme Court ruling, frankly, I am sometimes not sure the government wants me to stay in business and continue to grow.

Previously, I was allowed to deduct my home office expenses because I had no other office available. My home office space is dedicated solely to my business, and I generated more than enough income to cover the value of the deduction. I never tried to use the office deduction to create a loss situation. I just want to be able to deduct reasonable expenses that other businesses are entitled to.

I am now denied an annual deduction of $3,330 and will incur $910 in additional tax liability. This means I have to generate approximately $20,000 in new sales just to get back where I was before the deduction was removed. This money could have gone back into my business in the form of equipment, trucks, ladders, sprayers. It could have gone into my retirement. It could have gone into anything—back into the economy.

I understand there is widespread support for restoration of this home office deduction among broad-ranging groups, many of which are represented here today and in Congress. NARI strongly supports restoration of this home office deduction. A survey conducted by our membership showed overwhelming support to restore the deductions. Even companies that had an office outside their home approve of it because they probably started at home.

We are pleased to see this home office deduction find its way into the Contract With America. Congress has a big opportunity to restore that which the Court has taken away. Personally, I will be thrilled to see Congress act in a way to help the small entrepreneurs. We have shouldered too many regulatory burdens over the years.

Again, thank you, Mr. Chairman, and your staff for inviting me to appear before you today to bear witness to the need for this legislation. I am willing to answer any questions. Thank you.

[The prepared statement follows:]

NATIONAL ASSOCIATION OF
THE REMODELING INDUSTRY
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Statement of
Don Strong, Brothers Strong, Inc.
and the
National Association of the Remodeling Industry
before the
House Ways and Means Committee
regarding the
Restoration of the Home Office Deduction
February 1, 1995

NARI

Mr. Chairman, honorable members of the Committee, I am honored to provide testimony in support of the proposed restoration of the home office deduction. My name is Don Strong and I am the principal owner of Brothers Strong, Inc., a small remodeling firm specializing in residential remodeling. I currently have five full-time employees and six subcontractors. I operate out of a separate office located in my home. I am also a member in good standing of the National Association of the Remodeling Industry (NARI). I appear today in complete support of efforts taken by you, Mr. Chairman, this Committee, and others to restore the home office deduction provisions that were significantly restricted by the U.S. Supreme Court ruling, *Commissioner of the IRS v. Nader Soliman*, in January 1993.

The Court's ruling put a severe crimp in the ability of small business owners, like myself, to further grow their home-based and/or start-up businesses. Before the Court's ruling I could deduct a reasonable portion of my home office overhead expenses— just as other businesses can if they operate out of another location. I simply prefer to keep my business in my home. I think it is unfair having lost this deduction.

The Court's ruling added two new eligibility tests that remodelers simply cannot meet. First, the Court and the law now require that business owners *must have customers come to their home office*. In service-based businesses, such as residential remodeling, it is I who must travel to the customer's home to discuss possible home improvement projects. I need to see what their home is like, what they want done, and where. It is inconceivable for a remodeler to develop a remodeling project site unseen.

Second, the law now requires that the business' *income must be generated within the home office*— not from transactions that occur outside the home office. Again, it is impossible for a remodeler to remodel a home from his home office. The income generating activity is conducted at the client's home.

So if I am out selling jobs in the community and doing the remodeling on location, what is it that I do in my home office that is so important, the IRS might ask. Why do I deserve this deduction?

I use my home office to perform all the activities any remodeler needs to do to effectively run his or her business. I prepare estimates, contracts, plans, and marketing materials in my home office. I develop leads, make business phone calls, organize material deliveries, solicit subcontractor bids, and research industry and product trends in my home office. I record all business transactions, receipts and expenses, tax responsibilities in my home office. I maintain all relevant regulatory information such as OSHA MSDS sheets, hazard communication and worker protection safety plans, EPA lead-based paint rules, and IRS record keeping requirements in my home office. This is where I pay my bills. This is where I contribute to the U.S. Treasury.

In my home office, I have three separate phone lines, a fax machine, three computers and a printer, and a small copier machine— everything a small office needs to conduct business. If I preferred to rent an outside space, my entire overhead would be deductible without question. Because I choose to remain in my home, I can no longer deduct reasonable office expenses. But, I have no need to rent space. My business has grown to a comfortable level and runs efficiently from my home office.

Previously, the law allowed me to deduct that portion of my home office expenses because 1) I had no other office available, 2) my home office space is dedicated solely to my business, and 3) I generated more than enough income to cover the value of the deduction. I never tried to use the office deduction to create a loss situation. I just want to be able to deduct reasonable expenses that other businesses are entitled to. Now I cannot deduct these overhead expenses and will incur $910.00 in additional tax liability. This money could have gone into my business, perhaps a new truck or ladder or computer. This money could have gone into my grandson's college fund. This money could have gone into my personal retirement account. This money could have gone to my favorite charity, Northwest Assistant Ministries .

I understand there is widespread support for restoration of the home office deduction among broad ranging groups, many of which are represented here today, and in Congress. NARI is a strong supporter of restoring the home office deduction. A survey conducted of our membership showed overwhelming support for the restoration. Even companies that had an outside office supported the move, perhaps because many successful remodelers started in their homes. Last year, NARI pushed for enactment of H.R.3407, co-sponsored by Representatives Peter Hoagland and Nancy Johnson and S. 1924, by Senators Hatch, Exon, and Lieberman.

We are very pleased to see the home office deduction find its way into the Contract with America. Congress has a unique opportunity to restore that which the Court has taken away. Personally, I will be thrilled to see Congress act in a way to help small entrepreneurs. We have shouldered too many regulatory burdens over the years. This legislation is a step in the right direction. We stand ready to assist in its passage however we can.

Again, I thank you Mr. Chairman, for inviting me to appear before you and your committee today to bear witness to the need for this positive legislation. I am willing to answer any questions I can.

Respectfully Submitted,

Don Strong
Brothers Strong, Inc.
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NARI is a not-for-profit trade association with nearly 6,000 member companies nationwide, representing over 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors, and include national manufacturers and distributors of home improvement products and services.

Residential remodeling constitutes a $100 billion industry that has grown over 130 percent in the last ten years. With over 50 years of experience, NARI is committed to enhancing the professionalism of the remodeling industry and serving as an ally to homeowners. NARI is dedicated to the growth and betterment of the remodeling industry and related small businesses. For more information about NARI, contact Patti Burgio, director of government affairs, NARI, 4301 North Fairfax Drive, Suite 310, Arlington, VA 22203, 703/276-7600.

Mr. BUNNING. Thank you, Mr. Strong.
Mr. Diedrich.

STATEMENT OF TOM DIEDRICH, THE DIEDRICH GROUP, MINNETONKA, MINN., AND TREASURER, BUREAU OF WHOLESALE SALES REPRESENTATIVES, ON BEHALF OF THE NATIONAL ASSOCIATION OF THE REMODELING INDUSTRY, ARLINGTON, VA.

Mr. DIEDRICH. Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today.

My name is Tom Diedrich, and I am an independent salesperson living in Minneapolis, Minn. I am also an active member of the Bureau of Wholesale Sales Representatives and currently serve as treasurer of this organization. The bureau is an Atlanta-based national association of approximately 10,000 apparel or kindred merchandise sales representatives. I am married, and my wife, Lynn, is also an independent sales representative.

I own and manage a wholesale apparel business, The Diedrich Group, and my only office is in my home. It appears I am part of an ever growing number of entrepreneurs and independent businesspeople who choose to work out of their homes. The January 7, 1995, program, "How to Succeed in Business," on CNBC stated that approximately 25 million people may soon be working out of their homes.

It is often said that the majority of American businesses started out in someone's home. Well, I can report to you that today the reverse is true. A great number of American businesses, some small and some not so small, are moving back into the home.

You might ask why. As commercial rental costs rise and as technology progresses, the home becomes a more efficient place to do business. The home continues to be the birthplace of the majority of successful new business ventures.

As an independent sales representative, I am responsible for the wholesale marketing of several lines of apparel. I present these lines to retail buyers and obtain orders from retailers to carry these lines in their stores.

In my industry and in many others, the sales function is highly reliant upon personal contact. I meet with my customers at regional markets and trade shows or by means of personal, one-on-one presentations in retail stores throughout my territory.

I drive in excess of 25,000 miles each year to see these customers, and I attend approximately 25 trade shows each year as well. My territory consists of a six-State area in the Upper Midwest. I spend more time in hotel rooms than in my own bed, and my four-star hotel is not the Ritz, but the Red Roof.

The tools of my trade are the samples of the clothing that I represent. These samples must be steamed, hung and grouped in garment bags. When traveling, sales reps hang these bags in show vans or full-size cars, often larger than we would otherwise choose but necessary for us to carry our samples and other business supplies like spotlights, order forms, garment racks and suitcases. Our business trips can be as short as 1 day or as long as 2 weeks. But when we are at home, we must store our samples, which consume a full room at our home.

Though important, the personal presentation is only one element of selling, and it is not the definitive close to the large majority of my sales. More critical and often more productive is the pitch-and-shovel work done on the telephone, the fax machine or through the mail.

This is why my office is so vital to my business. It is the very nerve center, the very base of operations. And, of course, like any small business I must maintain massive volumes of records in order to meet Federal, State and local tax-reporting requirements. My office, whether it is in an apparel mart or at home, is essential to successfully managing my business.

For many years, I maintained an office in the Minneapolis Apparel Mart. My office in the mart was never subsidized by any of the manufacturers I represented. The costs of maintaining that office continued to rise and, at the same time, new technologies enabled me to conduct my business from home. The choice to move home became obvious to The Diedrich Group. I am not alone in making this decision, especially in our industry.

Independent sales representatives work on a commission basis. We have no corporate credit cards to cover hotel rooms, no company car allowance, no company-paid health care or retirement plans. We are independent in every sense of the word, and yet we are dependent upon tax policies that will give us the opportunity to compete and prosper.

The *Soliman* ruling sets certain standards for determining the deductibility of a home office. My home office does not meet those standards because I do not routinely meet with customers in my home. But the fact is that my office is absolutely essential to my business, and it should be treated as a business expense for tax purposes.

In my office, you will find file cabinets with records, a desk and chairs, fax machine and copy machine, separate telephone lines with an answering machine, a computer and a printer. This room is used strictly for business purposes.

Also in my home, in a separate room, I have 30 feet of pipe rack to store samples, which are the tools of my industry; a steamer that is used to steam wrinkles out of the samples; spotlights that are portable for shows—which I carry with me to the trade shows; six rolling racks that I use to move and display my samples; and huge travel bags, called garment bags in the industry, that protect my samples from damage.

All of these items are vital to my profession. At one time, all were found in a separate office outside my home. When I rented my office 15 miles from my home, I was able to deduct that expense. Today, however, when more people seek to work from their home and when technology makes working from home not only feasible but highly efficient, the Federal Government effectively punishes the home-based business by taking away the home office deduction.

We, the independent sales representatives of this Nation, ask you to give back what the Supreme Court took away in 1993. We ask only for what was legitimately ours: The right to deduct a place of business regardless of its location. This deduction should be available for the office space that is required to run a small business as well as for the space required to store the tools of our trade—in my case, samples. We ask that you correct this inequity and restore our right to the home office deduction.

The solution to solving the home office deduction problem for bureau members requires legislative action. The suitable solution for independent sales representatives must include language to resolve the issue of storage of product samples, as well as generic language to permit active and ongoing small businesses to take a home office deduction.

The solution should also instruct the IRS and the courts to reject using numerical tests as the basis for determining the importance of the home office as the principal place of business.

Last year, Congressman Wayne Allard of Colorado introduced legislation to address the concerns of bureau members regarding home office deductibility and deductibility of space devoted to storage of product samples. Congresswoman Johnson, a member of this committee, also introduced general language that incorporated both the product samples issue as well as broad-based solutions for home office deductions. This language is also included in the legislation that you have recently introduced as part of the Contract With America.

Mr. BUNNING. Mr. Diedrich, your time has expired.

Mr. DIEDRICH. Thank you.

[The prepared statement follows:]

TESTIMONY OF TOM DIEDRICH
MINNETONKA, MINNESOTA

Chairman Archer and members of the Committee, thank you for the opportunity to appear before you today.

My name is Tom Diedrich, and I am an independent salesperson living in Minneapolis, Minnesota. I also am an active member of the BUREAU OF WHOLESALE SALES REPRESENTATIVES and currently serve as Treasurer of this organization. The Bureau is an Atlanta based national association of approximately 10,000 apparel or kindred merchandise sales representatives. I am married, and my wife Lynn is also an independent sales representative.

I own and manage a wholesale apparel business, The Diedrich Group, and my only office is in my home. It appears I am part of an ever growing number of entrepreneurs and independent business people who choose to work our of their homes. The January 7, 1995 program of How to Succeed in Business on CNBC stated that 25 million people will soon work full time our of their homes!
It's often said that the majority of American businesses started out in someone's home. Well, I can report to you that today, the reverse is true. A great number of American businesses, some small, some not so small, are moving back into the home. As commercial rental costs rise, and as technology progresses, the home becomes a more efficient place to do business. The home continues to be the birthplace of the majority of successful new business ventures.

As an independent sales representative, I am responsible for the wholesale marketing of several lines of apparel. I present these lines to retail buyers and obtain orders from retailers to carry these lines in their stores.

In my industry and in many others, the sales function is highly reliant upon personal contact. I meet with my customers at regional markets or trade shows, or by means of personal, one-on-one presentations in retail stores throughout my territory. I drive in excess of 25,000 business miles each year to see these customers, and I attend approximately 25 trade shows each year as well. My territory consists of a six-state area in the Upper Midwest. I spend more time in hotel rooms than in my own bed, and my four-star hotel is not the Ritz, but the Red Roof.

The tools of my trade are the samples of the clothing that I represent. These samples must be steamed, hung and grouped in garment bags. When traveling, sales reps hang these bags in showvans or full size cars, larger than we would otherwise choose but necessary for us to carry our samples and other business supplies, like spotlights, order forms, garment racks, and suitcases. Our business trips can be as short as one day or as long as two weeks, but when we're at home, we must store our samples, which consume a full room, at home.

Though important, the personal presentation is only one element of selling, and it is not THE definitive close to the large majority of my sales. More critical and often more productive is the pitch-and-shovel work done on the telephone, fax machine, or through the mail. This is why my office is so vital to my business. It is the nerve center, base of operations. Of course, like any small business, I must maintain massive volumes of records in order to operate efficiently and to meet federal, state and local tax reporting requirements. My office, whether it's in an apparel mart or at home, is essential to successfully managing my business.

For many years, I maintained an office in the Minneapolis Apparel Mart. My office in the Mart was never subsidized by any of the manufacturers that I represented. The costs of maintaining that office continued to rise, and at the same time, new technologies enabled me to conduct my business from home. The choice to move home became obvious for The Diedrich Group. I am not alone in making this decision, especially in our industry.

Independent sales representatives work on a commission basis. We have no corporate credit cards to cover hotel rooms, no company car allowance, no company-paid health care or retirement plans. We are <u>independent</u> in every sense of the word and yet we are <u>dependent</u> upon tax policies that will give us the opportunity to compete and prosper!

The Soliman ruling set certain standards for determining the deductibility of a home office. My home office does not meet those standards, because I do not routinely meet with customers in my home. But the fact is that my home office is absolutely essential to my business, and it should be treated as a business expense for purposes of tax liability.

In my home office, you will find: file cabinets with records; a desk and chairs; Fax machine and copy machine; separate telephone line; a computer and printer. This room is used strictly for business purposes. Also in my home, in a separate room, I have: 30 feet of pipe rack to store samples, which are the tools of my trade; a steamer to steam the wrinkles out of the samples; spot lights that are portable, which I carry with me to trade shows; six rolling racks that I use to move and display my samples; and huge travel bags, called "garment bags" in the industry, that protect my samples from damage.

All of these items are vital to my profession. At one time all were found in a separate office outside my home. When I rented office space 15 miles from my home, I was able to <u>deduct</u> that expense. Today, however, when more people seek to work from home and when technology makes working from home not only feasible but highly efficient, the federal government effectively punishes the home based business by taking away the home office deduction!

We -- the independent sales representatives of this nation -- ask you to give back what the Supreme Court took away in 1993. We ask only for what is legitimately ours: the right to deduct a place of business, regardless of its location. This deduction should be available for the office space that is required to run a small business, as well as for the space required to store the tools of our trade (in my case, samples). We ask that you correct this inequity and restore our right to the home office deduction.

The solution to solving the home office deduction problem for Bureau members requires legislative action. The suitable solution for independent sales representatives must include language to resolve the issue of storage of product samples, as well as generic language to permit active and ongoing small businesses to take a home office deduction. The solution should also instruct the IRS and the courts to reject using numerical tests as the basis for determining the importance of the home office as the principal place of business.

Last year, Congressman Wayne Allard of Colorado introduced legislation to correct the concerns of Bureau members regarding home office deductibility and deductibility of space devoted to storage of product samples. Congresswoman Johnson, a member of this Committee, also introduced general language that incorporated both the product samples issue, as well as a broad-based solution for home offices.

This language is also included in the legislation that you recently introduced, Mr. Chairman, as part of the "Contract with America," specifically in Sections 12003 and 12004. We are pleased to note that this language is nearly identical to the proposal introduced last year by Congresswoman Johnson, which was endorsed by many members of Congress, and of this Committee.

In closing, I would also note that, because of the nature of our business, it is often difficult to interpret statutory language of this kind as it applies to our industry. I would therefore suggest that the Committee consider clarifying report language, that would leave no doubt as to the intent of this body in respect to the impact of this legislation on independent sales representatives.

Thank you for the opportunity to appear before you today, and I am available for any questions you may wish to ask.

Mr. BUNNING. Thank you very much for your testimony.

Dr. Cohen, please.

STATEMENT OF STEVEN J. COHEN, D.V.M., MOBILE VETERINARY SERVICES OF NORTHERN VIRGINIA, ON BEHALF OF THE AMERICAN VETERINARY MEDICAL ASSOCIATION, WASHINGTON, D.C.

Dr. COHEN. Mr. Chairman and members of the committee, good afternoon. Thank you for the opportunity to testify before you today. My name is Dr. Steven J. Cohen, and I am affected by the *IRS* v. *Soliman* ruling. I represent many veterinarians throughout the United States who, as small business men and women, have an interest in the home office deduction issue. I am also here as a member of the American Veterinary Medical Association, a national veterinary organization representing over 56,000 practicing veterinarians.

The AVMA supports the restoration of the home office deduction and is a part of the effort on this with the National Association of the Self-Employed.

Since 1980, I have operated a veterinary house call practice in northern Virginia. That is, I see my patients and their owners in their homes. My practice fills a niche for many situations. There are those clients who prefer to have their pets treated at home simply as a convenience. Many of these owners have multiple pet households. There are owners, particularly the elderly or disabled, where transportation of their animals is difficult as well as inconvenient.

Furthermore, my practice facilitates prompt medical care to those animals whose owners have medical, transportation or time constraints that could obstruct their ability to seek necessary or critical professional veterinary care in a timely manner for their animals.

As a sole proprietor business, my primary job is to practice veterinary medicine. However, in order to do this, my other job is being a small business owner and operator. As a practitioner owner, the two jobs cannot be mutually exclusive.

As with any business, an office must be maintained. Business records, tax records, patient files, business telephone lines, professional and business references are maintained in my office—which happens to be a room in my house used exclusively for this purpose.

My home office is obviously convenient for me. I do not incur an additional expense renting space elsewhere to accommodate my needs. I do not waste additional time commuting to my office. Obviously, I already spend a great deal of time on the road, and this decreases energy expenditures and costs as well as personal safety risk.

I do consult with owners over the phone from my home office, but I do not see patients there. House call appointments are set up and patient records are maintained in my home office.

If I conducted a conventional veterinary practice in a facility away from my home, all of the costs incurred in running that business, including the business office where the primary activity of practicing veterinary medicine is not performed, would be deductible as a business expense on my schedule C tax return.

By comparison to most conventional veterinary practices in northern Virginia, I am a very small business. I only see about 650 different owners each year as compared with 1,500 or more that my colleagues see. Due to travel time constraints, I see about 8 to 10 owners and their pets per day versus 35 or more in a conventional practice. Because of this, I must minimize costs. One way to do this is to maintain an office in my home.

As you are well aware, the recent Supreme Court ruling held that unless the primary job function is performed in the home office, this deduction is disallowed. If one is running a business, it follows a business office is a necessity. The location of that business office should be irrelevant as far as the Tax Code is concerned.

Before the recent court ruling, my home office saved me about $700 a year. This is money that I could invest in new equipment, improve my library, enhance my skills through continuing education and, of course, save for the future.

Those of us who do professional consulting at multiple sites should have the same tax advantages as our conventional counterparts. As an added bonus, with less time spent traveling to a separate business office, I am able to spend a little more of the precious little time there is with my family.

Thank you, Mr. Chairman. I will be happy to address your questions and those of the members of the committee.

Mr. BUNNING. Thank you for your testimony.

Mr. Davis.

STATEMENT OF HENRY DAVIS, PRESIDENT, HENRY DAVIS CONSULTING, NATICK, MASS., ON BEHALF OF THE NATIONAL HOME OFFICE ASSOCIATION

Mr. DAVIS. Thank you.

My name is Henry Davis, president of Henry Davis Consulting, a home-based business. I am here today representing the National Home Office Association.

My company is a good example of how the new breed of information workers provide services and what they are capable of doing from their homes. I specialize in providing new product consulting to companies that use or produce technology-based goods and services. Our services include product planning, introduction, marketing, definition and assessment.

Prior to starting Henry Davis Consulting, I spent 20 years employed in the semiconductor and software industries. I have authored over 130 articles and papers on computer and semiconductor technology and its applications. My contributions to industry have been recognized by Electronics Magazine, the American Electronics Association and others.

For the last 3½ years, I have consulted to big companies, such as IBM and Texas Instruments, while providing guidance to small emerging companies like BEARAK REPORTS, a financial services company.

Modern computer technology, coupled with networks like the Internet, provide the infrastructure I need to maintain an electronic presence for my customers no matter where I am physically located. My home office provides the physical location for computers, phones and facsimile communications. The telephone network and Internet allow me to appear as if I am in my office even if I am halfway around the world. Modern technology permits me to work where I am—on a plane, in a hotel room or even here at these hearings. Communication with my office and customers is a phone call away. Even a cellular phone will work.

The very idea of an office is changing throughout business. Time-sharing offices, called hotelling, are becoming more popular among companies whose employees spend most of their time at client sites, on the telephone or in front of a computer.

For the home-based business, the home office becomes sort of a communications central. These rapid and profound changes in how we do business demand changes in how our businesses are managed and how we account for our expenses.

The current tax regulations governing deductibility of home offices are hopelessly outmoded. New technology and new ways of doing business mean that for a growing segment of both home-based and -operated workers, the office is becoming an electronic presence visited only to perform necessarily administrative functions. This improves financial productivity, reduces the commuting burden on our roads and highways, is environmentally beneficial and increases the amount of time we have to spend with our families.

Home-based businesses are the fastest growing segment of businesses in the United States. In the last economic recovery, home-based businesses created millions of productive new jobs. Projections are for these small businesses to continue their phenomenal growth and create at least 12 million new jobs by the year 2005. There are an estimated 24 million people who operate businesses from their homes today.

It is time for legislative change to remove the penalties home-based businesses face simply because they happen to be located in a residence.

Let me personalize the impact of home office deductions. Twenty-five percent of my home is dedicated to maintaining an office and professional library. My office serves the usual functions, including a place to write and maintain business records. The office is used only for business and is unusable by my family in my absence. Most importantly, my office provides an electronic presence, including voice mail and 24-hour-per-day computer access when I am away.

In 1993, I traveled over a half million air miles to work with clients at their locations. I was away from my home office more than 90 percent of the time. In 1994, my work kept me out of the office 80 percent of the time. If I had my office in a commercial office building, my office costs could have been deducted as a cost of doing business. But, because my income was based on work performed outside my home office, I am effectively precluded from claiming the deduction.

In my case, my home office would have been worth the tax savings of $1,050 in 1994. To put the value of home office deductions in perspective, my tax savings could have paid for "2 hours of business telephone calls so I could find 5 more clients, or paid for 8 months of classified advertising and found 8 more clients, or paid for direct mail program to gain 5 more clients or, alternatively, paid all expenditures for attendance at a trade show.

This would have resulted in additional taxable income of $25,000. At the marginal tax rate of 28 percent, that $1,050 home office deduction could have produced a net tax revenue increase from my business of at least $5,950.

The way in which we do business is changing rapidly. When I travel around the world, I can use my home office-based computers by using a notebook computer and modem. While I may be sitting in a hotel, on an airplane or in a client's office, work is being done electronically in my home office. Faxes, messages and information are all routed to me in my home office and can be available to me anywhere in the world at the push of a button. I don't need to be in my office, but I do need the office. I work in my office electronically.

Home-based businesses are mostly cash-flow-based businesses. We do not have a ready equities market. There is little in the way of business loans. And lines of credits are generally not available to us. We run our businesses based on short-term positive cash flow and controlling costs. Having our offices in our homes is one way of controlling overhead.

Big business turns to home-based business for outsourcing. We reduce costs and can often do a better job. These same big businesses are able to deduct the cost of office space that is not even occupied. It is empty or shut down. At the same time, home-based businesses have barriers in the way of deducting dedicated home offices just because we do not spend all of our time in the office.

It is not right. It is not reasonable. It is bad for business. Its bad for the country.

Thank you for your attention.

[The prepared statement follows:]

TESTIMONY OF HENRY DAVIS
NATICK, MASSACHUSETTS

My name is Henry Davis, President of Henry Davis Consulting--a home-based business. I am here today representing the National Home Office Association. My company is a good example of how the new breed of information workers provides services, and what they are capable of doing from their homes. I specialize in providing New Product Consulting to companies that use or produce technology-based goods and services. Our services include product planning, introduction, marketing, definition, and assessment. Prior to starting Henry Davis Consulting, I spent 20 years employed in the semiconductor and software industries. I have authored over 130 articles and papers on computer and semiconductor technology and its application. My contributions to industry have been recognized by *Electronics Magazine*, the American Electronics Association, and others.

For the last three and one-half years, I have consulted to big companies, such as IBM and Texas Instruments, while providing guidance to small, emerging companies like BEARAK REPORTS, a financial services company. Modern computer technology, coupled with networks like the Internet, provide the infrastructure I need to maintain an electronic presence for my customers no matter where I am physically located. My home office provides the physical location for computers, phones and facsimile communications. The telephone network and Internet allow me to appear as if I am in my office, even if I am half way around the world. Modem technology permits me to work where I am--on a plane, in a hotel room, or even here at these hearings. Communication with my office and customers is a phone call away. Even a cellular phone will work.

The very idea of an office is changing throughout business. Timesharing offices, called hotelling, are becoming more popular among companies whose employees spend most of their time at client sites, on the telephone or in front of a computer. For the home-based business, the home office becomes a sort of communications central. These rapid and profound changes in how we do business demand changes in how our businesses are managed, and how we account for our expenses.

The current tax regulations governing deductibility of home offices are hopelessly out-moded. New technologies and ways of doing business mean that for a growing segment of both home-based and corporate workers, the office is becoming an electronic presence visited only to perform necessary administrative functions. This improves financial productivity, reduces the commuting burden on our roads and highways, is environmentally beneficial, and increases the amount of time we have to spend with our families.

Home-based businesses are the fastest-growing segment of business in the United States. In the last economic recovery, home-based businesses created millions of productive new jobs. Projections are for these small businesses to continue their phenomenal growth and create at least 12 million new jobs between 1992 and the year 2005. There are an estimated 24 million people who operate businesses from their homes today.

It's time for legislative change to remove the penalties home-based businesses face simply because they happen to be located in a residence.

Let me personalize the impact of home office deductions. Twenty-five percent of my home is dedicated to maintaining an office and professional library. My office serves the usual functions, including a place to write and maintain business records. The office is used only for business and is unusable by my family in my absence. Most importantly, my office provides an electronic presence, including voice mail and 24 hours per day computer access, while I am away.

In 1993, I travelled over 500,000 air miles to work with clients at their locations. I was away from my home office more than 90% of the time. In 1994, my work kept my out of the office 80% of the time. If I had my office in a commercial office building, my office costs could have been deducted as a cost of doing business. But, because my income was based on work performed outside my home office, I am effectively precluded from claiming the deduction.

In my case, my home office would have been worth a tax savings of $1,050 in 1994. To put the value of a home office deduction in perspective, my tax savings could have:

- paid for 112 hours of business telephone bills to find 5 more clients
- paid for 8 months of classified advertising to find 8 more clients
- paid for a direct mail program to gain 5 more clients
- paid all expenditures for attendance at a trade show.

This would have resulted in additional taxable income of $25,000. At the marginal rate of 28%, that $1,050 home office deduction could have produced a net tax revenue increase from my business of at least $5,950.

The way in which we do business is changing rapidly. When I travel around the world, I can use my home office-based computers by using a notebook computer and modem. While I may be sitting in a hotel, on an airplane or in a client's office, work is being done electronically in my home office. Faxes, messages, and information are all routed to me in my home office and can be available to me any where in the world at the push of a button. I don't need to be In my office, but I do need the office. I work in my office electronically.

Home-based businesses are mostly cashflow-based businesses. We don't have a ready equities market, there is little in the way of business loans, and lines of credit are generally not available to us. We run our businesses based on short-term positive cashflow and controlling costs. Having our offices in our homes is one way of controlling overhead.

Big business turns to home-based businesses for outsourcing. We reduce costs and can often do a better job. These same big businesses are able to deduct costs of office space that isn't even occupied; it's empty and shutdown. At the same time, home-based businesses have barriers in the way of deducting dedicated home offices just because we don't spend all of our time in the office.

It isn't right. It isn't reasonable. It's bad for business and the country.

Thank you for your attention.

Mr. BUNNING. Thank you, Mr. Davis.

Mr. McCrery will inquire.

Mr. MCCRERY. Mr. Chairman, I don't really have any questions. I appreciate the testimony of the witnesses. I think they made some excellent points.

About the only thing that I am concerned about with respect to this issue—and maybe I will just throw this out to the panel—what about potential for abuse of this? I agree that we need to clarify and we need to, as Mr. Davis says, make it easier to take the deduction, but how do we prevent somebody from taking advantage of this and abusing the home office deduction if we do expand it?

Mr. DAVIS. If you look at the way the Tax Code had been originally set up or prior to this Supreme Court ruling, to the extent that my home office was not greater than income derived, then I was able to take that as a deduction. In other words, I could not use it to create a tax-loss situation.

I think, by and large, as home-based businesses become more the norm, and with 40 million people today earning some kind of a living at home, people become more aware of how to deal with the Tax Code. If you make it simple and make it easy and straightforward, then there is not much in the way of motivation for people to rip off the government.

What is really at work here is putting the capital, putting the money in people's hands who can best use it. And in my case, I gave you an example where there is a 25-to-1 payback, and, not only that, a 6-to-1 payback in new taxes.

It seems to me that the small amount of abuse that might occur is more than offset by everybody's here ability to create more income and more tax as a result.

Mr. MCCRERY. Anybody else like to comment? No? Nobody is worried about potential abuse?

Ms. OBERMAYER. I think that one of the things you need to look at is that the code, as it was before this decision, was actually quite restrictive in the use of this anyway. You must use the place strictly for your business and for no other use.

And my understanding from my accountant is that if you really try to take any significant deduction in that area you are inviting a red flag. That is, the IRS has really been very, very hard on people in this area; and you do not do it unless you are really sure that you have a clean case.

Mr. FORSYTHE. I would comment that in my function as vice president of tax for Ecolab we talk to auditors all the time, and I think that she is very right. This is a red flag. And it is the type of thing that you are either going to be able to prove it pretty easily or you are going to lose it, I think.

Mr. MCCRERY. OK.

Well, again, Mr. Chairman, I think the testimony has been excellent; and I don't mean to imply that that concern of mine will override my other concern, which is to make the Tax Code simpler and easier to use for home office deductions. So I am hopeful that we will get something out of committee to give you some relief. Thank you.

Mr. BUNNING. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I, too, applaud the excellent testimony we received from this panel. What is most refreshing, I believe, is the real-world input that you provide. Under the new regime we have made a real effort to get people who are directly affected rather than academics and ivory tower types and policy wonks who we have seen too many of in the Congress. And it is very refreshing to see real-world people testify about real-world policies and how they are impacted.

As one who shares the consensus here that clarifying the home office deduction would make a major difference to thousands of small businesses across this country, I was very interested, Mr. Forsythe, in your testimony. You remarked that for the Ecolab sales force that home offices are the most efficient and most cost effective way to create productive and high-paying sales jobs.

I would just ask if you have any way of quantifying or projecting—if not empirically, anecdotally—how many jobs—how much impact this change, this clarification might have?

Mr. FORSYTHE. Well, I think it would affect the majority of our 2,000 direct sales personnel, but I think a very graphic explanation could be afforded by Dick Lane as to what he goes through in a typical day. Dick.

Mr. LANE. Thank you.

I am from South Dakota, and I have a territory that covers Nebraska and North Dakota. And by not having the home business deduction now, and a person that travels a lot, my typical day would be to get up in the morning and drive probably 200 to 250 miles, work with my account and drive back home that night. And then the next day turn around and drive 120 miles north and work with an account and drive back.

And by doing that, and not having the home office deduction, I have to claim that as personal miles. I think that by having to do that, it makes you do one of four things: One is, it encourages you to get an office out of the home, downtown or somewhere; number two, it encourages you to stop at a local account or a close account, that you would not really necessarily have to stop there every day. And you get to be pretty good friends with them, just stopping in, so that is considered your first stop.

I think the third thing it encourages you to do is to stay out overnight so that you do not drive back and have to encounter the personal miles coming back. And then, fourth of all, the last thing, is you claim it on personal miles.

I think by doing that—the first three things—it is an expense to my company, Ecolab, because they have to add it on to the cost of the good; and, in turn, it gets added on to the consumer. So the consumer pays for it in the long run.

And then, last, if I have to use it as personal miles, it taxes me, I think, unfairly for just trying to do an honest and fair job. Thank you.

Mr. RAMSTAD. Well, Mr. Chairman, I appreciate that. Again, that is very real world, very graphically explains the needs for this change in the law, and I am very pleased by the testimony of people who know how much this tax relief will help the self-employed and other workers who conduct their business at home.

This is really a big deal to many people I know in the Third District of Minnesota and throughout our State and country, and I appreciate again the testimony.

I just have one question I would like to ask Mr. Diedrich. You do not maintain an outside office currently?

Mr. DIEDRICH. No, sir, I do not.

Mr. RAMSTAD. What would be the comparable rent if you had to maintain such an office?

Mr. DIEDRICH. I had maintained an office and the rent structure was approximately $525 a month.

Mr. RAMSTAD. So it does not make a lot of financial sense to be required to maintain an outside office in order to be eligible for a corresponding deduction.

Mr. DIEDRICH. Absolutely. The function of my job has not changed. In fact, I am finding by working at home I function much better. I have less interruptions. The job I do at home is exactly the same job I would have done in the office, but I literally have more time working out of the office providing that same function.

Mr. RAMSTAD. Well, again, I want to thank all of the witnesses for your very helpful testimony.

Thank you, Mr. Chairman.

Mr. BUNNING. Mr. Payne.

Mr. PAYNE. Thank you, Mr. Chairman.

I have no questions but also wanted to thank the witnesses for their testimony. I think it has been very helpful.

As we all know, we are now approaching 25 million who are working in offices in their homes. As we are getting more and more into an information age that number will only increase. I think it is important that we act on what you have testified on here today. Thank you very much.

Mr. BUNNING. Mr. Ensign, if you would make sure that it is short, we would like to finish this panel before we go to vote. Thank you.

Mr. ENSIGN. I have a couple of quick comments.

Dr. Cohen, I appreciate your testimony, being a veterinarian myself.

By the way, if you ever get elected to Congress, you lose the doctor and you become a mister.

Mr. COHEN. My mother would not like that.

Mr. ENSIGN. Yes.

Addressing Mr. McCrery's comments, I want to ask why penalize all the honest people because of a few people that are going to take advantage of the situation? Sure, in any system that you set up, there will be fraud. Obviously, we have to do everything that we can to stop fraud, but should we penalize honest businesspeople because a few are going to take advantage of that?

I think you have given excellent testimony on the reasons why we should enact this legislation. And because a few people are going to abuse the system does not detract, in my opinion, from why we should give legitimate businesspeople, such as yourself, that legitimate business deduction.

Thank you, Mr. Chairman.

Mr. BUNNING. I would like to thank the panel for their very fine testimony, and we will recess to vote and then we will be back. Thank you.

[Recess.]

Mr. ENSIGN [presiding]. Welcome, panel.

Why do we not just go ahead and start with Mr. Foster and then Mr. McNutt, Mr. Turner, Mr. Lange, Mr. Thigpen, and then Mr. True.

Mr. Foster, we are under a 5-minute rule, so if you would please try to keep your testimony within the 5 minutes, we would appreciate that. Thank you.

STATEMENT OF J.D. FOSTER, PH.D., EXECUTIVE DIRECTOR AND CHIEF ECONOMIST, TAX FOUNDATION

Mr. FOSTER. Thank you, Mr. Chairman.

My name is J.D. Foster, and I am the executive director and chief economist of the Tax Foundation. I do appreciate the opportunity to appear before the committee to discuss the Federal gift and estate tax.

The Tax Foundation is a nonprofit, nonpartisan research and public education organization. We are not a trade organization. We do not lobby specific legislation. We just try to assess the economics of taxes as best we can.

My written testimony provides a short history of the estate tax, some graphical analysis of estates by size and composition and a short discussion about estate tax relief targeted toward family businesses.

The estate tax is most often justified as a revenue source, by the perceived needs to ensure a particular sense of fairness in the overall tax system, and to govern who receives the fruits of our economic system. Against this social policy must be weighed the questions of fairness to the individuals paying the tax and the economic costs imposed on the taxpayer and on society as a whole.

The gifts and estate tax is obviously a tax on capital and, as such, is a disincentive to saving and investment. Anyone facing the tax has a tremendous incentive to dispose of his or her resources either through personal consumption or charitable contributions. Consuming more just to reduce estate taxes wastes precious resources, which we cannot afford to do in this country with our low savings rate.

For many businessmen, the estate tax also poses a disincentive to the long hours and hard work associated with success. Successful businessmen, at some point, face the prospect that after all the Federal, State, and local taxes have been paid and the remainder is saved and plowed back into the business, that the Federal Government will take up to half of what is left through the estate tax. And, at some point, they must surely ask themselves whether it would be better to continue to work so hard or to spend more time with their family or in other nonbusiness activities.

So the estate tax discourages work effort by some of the Nation's most productive and gifted citizens: The dreamers and visionaries whose hard work, skill, and luck have created new jobs and new markets.

The question is just how great a disincentive the estate tax is to this sort of productive activity. It is not an easy question to answer because the estate tax is a very different type of tax than one we are used to looking at.

Unlike sales and income taxes, we have little solid intuition or research about disincentive effects on taxes. To develop some intuition, we created a model that compares the disincentives of the estate tax with that of the income tax. Specifically, the model allows us to calculate how high the top income tax rate would have to rise to achieve the same disincentive as the estate tax.

Expressed another way, the model allows us to compare two scenarios: In one, an entrepreneur's life experience of work, saving, wealth creation and business expansion is considered in the context of the current tax law—individual, corporate and estate.

In the second scenario, the estate tax is eliminated, and the individual and corporate income tax rates are raised until they produce the same aftertax bequest as under the first scenario.

Simulations conducted using this model showed that the estate tax has roughly the same effect on entrepreneurial incentives as a doubling of income tax rates. In other words, Federal income tax rates would need to be nearly twice their current levels to produce the same disincentive as the current estate tax.

Now, just for an example, consider a businessman who is currently paying at the top income tax rate and whose noncorporate business is expected to allow him or her to leave an estate valued at $5.2 million. Under current law, this estate faces an effective marginal estate tax rate of about 44 percent. To achieve the same degree of disincentive through income taxes, it would be necessary to raise the effective individual income tax rate to 68 percent.

Now, since the Superbowl was played 3 days ago, I want to conclude with a sports analogy. Imagine a rule that says that for every touchdown scored by an individual player the team gets 6 points. But every time an individual player scores more than 1 touchdown, at the end of the game the team must give up 3 points per extra touchdown scored.

Now, Jerry Rice of the 49ers scored 3 touchdowns in the Superbowl, giving the 49ers 21 points. But if the NFL had an estate tax rule, at the end of the game the 49ers would have to give back 3 points for every touchdown they scored. He scored three. That means they have to give back 6 points.

Now, under these rules, Jerry Rice is not going to try as hard to score that second or third touchdown, particularly as he was playing with a dislocated shoulder. But that is what the estate tax looks like to a successful entrepreneur.

Analysis indicates that the estate tax creates a powerful influence on some of society's most productive workers—those whose effort has allowed them to create jobs and opportunities for others by offering goods and services demanded by others in the economy.

There is a very good reason why Adam Smith called his famous work on the power of the free market economy to create prosperity "The Wealth of Nations." The estate tax is a tax on that wealth, and, as such, a direct levy on prosperity.

Thank you, sir.

[The prepared statement and attachment follow:]

Statement of

J.D. Foster, Ph.D.
Executive Director and Chief Economist

Tax Foundation

on

The Gift and Estate Tax and Economic Performance

February 1, 1995

Mr. Chairman and Members of the Committee, my name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. It is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss the Federal gift and estate tax.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has monitored fiscal policy at all levels of government since 1937. The Tax Foundation is neither a trade association nor a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and clearly as we can the current state of fiscal policy and the consequences of particular legislation in the light of established tax principles, so that you, the policy makers, may make informed decisions.

Aside from its ability to raise revenue for the federal government, the estate tax is most often justified by the need to ensure a particular sense of fairness in the overall tax system and to govern who receives the fruits of our economic system. Against this social policy are raised the questions of fairness to the individuals paying the tax and the economic costs imposed on the taxpayer and on society as a whole.

The federal gift and estate tax is a unique feature of the federal tax system. It is not a tax on income, though it can influence the incentives to earn income; it is not a tax on consumption, though it can affect lifetime consumption; nor is it a tax on a particular activity. It is a tax on the net economic product of an individual after all other economic activity has concluded. As such, analysis of the distortions it imposes on the economy are unique and these will be the subject of my testimony.

Taxes distort the allocation of resources in the economy by altering the relative prices of goods, services, and factors of production like capital and labor. In the absence of taxes and other government policies, the economy tends to allocate its resources to produce those goods and services that are most in demand. Prices are the signals that indicate where resources should flow. Goods and services that command relatively high prices in the market, such as cars and medical attention, attract a greater flow of capital and labor than do products that command relatively low prices. Taxes alter the prices that direct the allocation of resources so that resources are directed towards less productive and less valuable uses, thereby reducing the quantity and value of the economy's product.

The nature of the disincentives imposed by the estate tax varies according to the economic state of the original wealth holder. For example, for an entrepreneur seeking to build a farm or business, the greatest disincentive effect is probably on his or her labor. The value of the business is the capitalized value of the entrepreneur's past and prospective personal efforts. As the estate tax looms larger, the disincentive grows and the amount of effort spent on building the business tends to decline. For those who have inherited wealth or who have sold their businesses after building them up, the estate tax creates a powerful incentive to consume this wealth since much of it will otherwise be lost to the federal government.

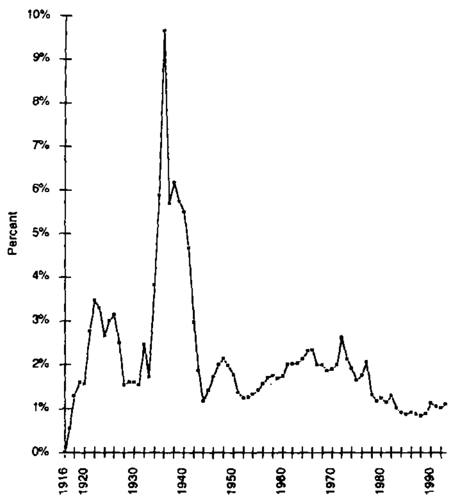
The Federal Gift and Estate Tax

The federal gift and estate tax is a system of tax rates, exemptions, credits, and special rules designed to transfer wealth from families to the federal government. This policy has two underlying justifications. The first is to raise revenue for the federal fisc and the second is to inhibit the accumulation of wealth beyond a certain level.

In total, there are 17 marginal transfer tax rates ranging from 18 percent to 55 percent. There is also a unified tax credit of $192,800 applying to lifetime gifts and bequests. And there is a rule which gradually phases out the benefit of the unified credit and progressive rate schedule by imposing an additional 5 percent tax on that portion of a transfer in excess of $10 million but less than $21.04 million.

The combined effect of the unified credit, graduated rate schedule, and benefit phase out rule is to

Figure 1
Transfer Taxes as a Percent of Federal Receipts
(1916 – Present)



Source: Internal Revenue Service.

federal revenue, though the nominal value of estate and gift tax receipts has grown steadily. In 1992, the U.S. government collected $11.1 billion in transfer taxes, predominately estate taxes, representing about 1 percent of total federal revenue.

Few changes in the transfer tax were made following the war until a series of legislation passed in 1976, 1981, and 1986 overhauled and modified the federal transfer tax system. Portions of the separate estate and gift tax systems were unified and levies were imposed on generation-skipping transfers. These Acts also lowered marginal transfer tax rates and significantly reduced the number of transfer tax returns filed each year by raising the filing requirements. See Figure 2 on page 4.

Two recent tax Acts have partially reversed some of the changes made over the previous 11 years. The Omnibus Budget Reconciliation Act of 1987 extended until 1992 the top marginal rate of 55 percent. This rate had been scheduled to fall to 50 percent. By enacting an additional 5 percent tax on transfers between $10 million and $21.04 million, the Act also phased out the benefits of the unified credit and graduated rate schedule over this range. These provisions expired on December 31, 1992, but were retroactively reinstated in the Omnibus Reconciliation Act of 1993. See Figure 3 on page 5.

Who Pays the Gift and Estate Tax

The value of the wealth reported on the estate tax returns filed for 1989 decedents (the latest year for which data is available) totaled almost $87.7 billion. The lion's share of this wealth, 31 percent, or slightly over $27.2 billion, was held by estates valued between $1 million and $2.5 million. The next largest share, 22.8 percent or $19.9 billion, was held by estates valued at between $600,000 and $1 million. Estates valued over $20 million held 14.1 percent of this wealth, or $12.3 billion. About 250 large estates (those with over $20 million in assets) file with the IRS each year. These estates are composed largely of business assets, such as closely held stock, farm assets, limited partnerships, and other non-corporate businesses. See Figure 4 on page 6.

Nearly one-half of all estate tax returns filed for 1989 decedents were for estates whose gross value exceeded $1 million. However, these estates accounted for nearly 96 percent of the total transfer tax receipts. Alternatively more than half of all returns were for $1 million or less, and these estates paid less than five percent of all estate taxes. Figure 5 on page 7 shows the distribution of federal estate tax returns for 1989 decedents by estate size. More than half of these returns, were filed for estates valued at between $600,000 and $1 million, while only 0.5 percent were filed for estates valued at $20 million or more.

Table 1
Marginal and Effective Transfer Tax Rates (1993)

Taxable Transfer (000s)	Statutory Marginal Tax Rate	Marginal Pre-credit Tax	Cumulative Pre-credit Tax	Cumulative Tax-Unified Credit	Effective Marginal Tax Rate	Effective Average Tax Rate
$10	18%	$1,800	$1,800	$0	0%	
			0%			
20	20	2,000	3,800	0	0	0
40	22	4,400	8,200	0	0	0
60	24	4,800	13,000	0	0	0
80	26	5,200	18,200	0	0	0
100	28	5,600	23,800	0	0	0
150	30	15,000	38,800	0	0	0
250	32	32,000	70,800	0	0	0
500	34	85,000	155,800	0	0	0
600	37	37,000	192,800	0	0	0
750	37	92,500	248,300	55,500	37	7.40
1,000	39	97,500	345,800	153,000	39	15.30
1,250	41	102,500	448,300	255,500	41	20.44
1,500	43	107,500	555,800	363,000	43	24.20
2,000	45	225,000	780,800	588,000	45	29.40
2,500	49	245,000	1,025,800	833,000	49	33.32
3,000	53	265,000	1,290,800	1,098,000	53	36.60
4,000	55	550,000	1,840,800	1,648,000	55	41.20
5,000	55	550,000	2,390,800	2,198,000	55	43.96
10,000	55	2,750,000	5,140,800	4,948,000	55	49.48
21,040	55	6,624,000	11,764,800	11,572,000	55	55.00
30,000	55	4,928,000	16,692,800	16,500,000	55	55.00
40,000	55	5,500,000	22,192,800	22,000,000	55	55.00
50,000	55	5,500,000	27,692,800	27,500,000	55	55.00
100,000	55	27,500,000	55,192,800	55,000,000	55	55.00

Source: Internal Revenue Service

create a range of effective marginal and average transfer tax rates that differs markedly from the statutory schedule, as shown in Table 1 on page 2. For example, while the statutory marginal tax rate on transfers between $600,000 and $1 million was 37 percent, the effective average tax rate on such transfers ranged from 0 percent to 15.3 percent.

A Short History of the Tax

The nation's first transfer tax was enacted in the final years of the 18th century when strained relations with France compelled the U.S. to develop a powerful navy. This force was funded by the Stamp Act of 1797, which required that federal tax stamps be purchased when transferring property from an estate. The cost of the stamp required to transfer property depended on the value of the estate and the size of the transfer. This tax was repealed in 1802.

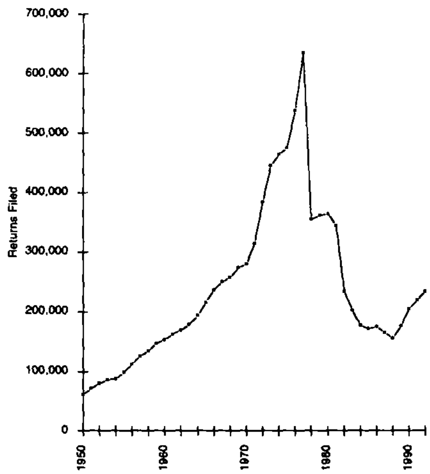
The federal government resorted once again to transfer taxes in the 1860s when the Civil War and subsequent reconstruction forced the Congress to look for additional federal revenue. A series of Acts passed in 1862, 1864, and 1866 created and refined the first federal inheritance tax. In 1870 Congress repealed this tax as demands for federal revenue eased. The transfer tax was once again enacted in 1898 to help finance the Spanish-American War. The tax was repealed in 1902. Prior to 1916, therefore, the federal government did not rely on transfer taxes as a permanent source of revenue, but, rather, levied the tax as a temporary source of revenue during national emergencies.

In 1916, the federal government enacted the estate tax along with the federal income tax. Sixteen years later, largely to prevent avoidance of the estate tax, the Congress enacted the gift tax. When it was enacted, the estate tax was imposed on estates in excess of $50,000 (about $650,000 in 1995) and the rate ranged from 1 percent to 10 percent.

The transfer tax reached its peak as a source of federal receipts in the period from 1932 to 1941, when transfer taxes accounted for as much as 9.7 percent of total federal receipts. However, while other taxes were raised during the Second World War, the transfer tax remained unchanged so that transfer tax receipts fell to 1.4 percent of total revenue by the end of the war. See Figure 1 on page 3.

With the exception of the mid-1930s, transfer taxes have never represented a significant share of

Figure 2
Total Transfer Tax Returns Filed
(1950 – Present)



Source: Internal Revenue Service.

The composition of estates varies significantly as the size of the estates increases. For example, as Figure 6 on page 8 shows, the percentage of the estate represented by business assets (closely held stock, farm assets, limited partnerships) grows steadily with estate size, while real estate and cash tends to decline as a share of estates as the estate size increases.

The Disincentive Effects of the Estate Tax

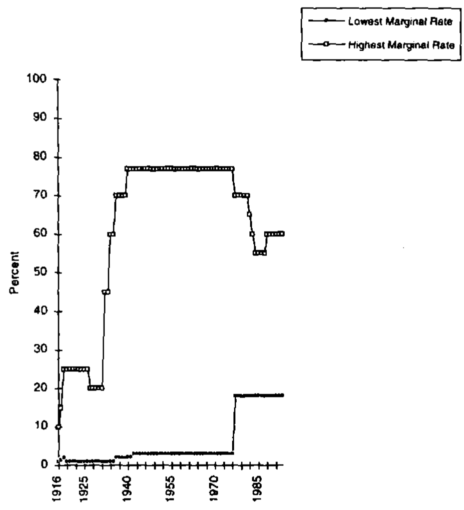
The gift and estate tax is a tax on capital and is universally recognized as a disincentive to save and invest. Anyone facing the tax has a tremendous incentive to dispose of his or her resources rather than let them be confiscated by the federal government. These dispositions may take any number of forms of personal consumption or charitable donations. While the latter may represent socially desirable behavior, increasing personal consumption to minimize the savings exacted by the federal government is a counterproductive dissipation of precious resources, particularly for a country that has such a low private saving rate.

For many taxpayers who are building up their personal wealth through their own labor, the gift and estate tax is also a powerful disincentive to the hard work and long hours associated with success. Successful businessmen at some point face the prospect that, after the federal, state, and local governments have imposed their income, property, and sales taxes on current income and assets, and the remainder is saved and plowed back into the business or other savings, the federal government will come along and take up to half of what is left through the estate tax. For individuals such as these, at some point they must surely ask themselves whether it would be better to continue to work so hard or to spend time with the family or on other, non-business related activities.

Thus, the transfer tax discourages work effort by some of the nation's most productive and gifted citizens—the dreamers and the visionaries whose hard work, skill, and luck have created new jobs and new markets. The question is, however, just how great a disincentive the estate tax is to this kind of productive activity.

This is not an easy question to answer because the estate tax is a very different type of tax than we are accustomed to examining. When a sales tax is levied, the effect is either to raise the price of the product being taxed or to shift the tax onto labor in the form of lower wages or onto capital in the form of lower after-tax earnings for a given level of pre-tax earnings. In each case, however, expe-

Figure 3
Estate Tax Marginal Rate Ranges
(1916 – Present)



Source: House Ways and Means Committee, 1993.

rience with sales taxes offers some intuitive sense of the consequences of a sales tax change of a certain size on a particular type of product.

Similarly, experience offers a relatively clear picture of the effects of income taxes on the disincentives to work. Research indicates, for example, that for males earning low to upper-middle income wages, the disincentive effect of higher marginal tax rates is fairly low, while that for all women tends to be higher. Research, in accord with common sense, also tells us that the disincentive effect of higher marginal tax rates rises rapidly once an individual's income reaches a certain level because the trade-off between the work required to earn an additional dollar of after-tax wages and enjoying the fruits of leisure quickly tilts in favor of leisure over labor.

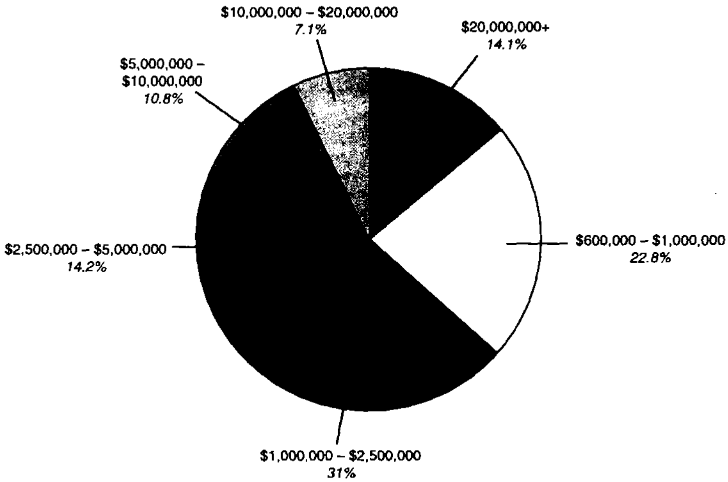
To clarify the effects of the estate tax on the incentive to work, the Tax Foundation developed a model that allows a comparison of the disincentive effects of the estate tax and the income tax. Specifically, the model allows a calculation of how high the top income tax rate would have to rise for it to achieve the same level of disincentive effect as the current estate tax regime.

Another way to think about the model is that it allows us to compare two scenarios. In the first scenario, an entrepreneur's life experience of work, saving, wealth creation, and business expansion is considered in the context of the current individual, corporate, and estate tax law. In the second scenario, the estate tax is eliminated and the individual and corporate income tax rates are raised until they produce the same after-tax bequest as under the first scenario. (The model is described in the Appendix to this testimony.) (pages 4 through 7 of the paper)

The various simulations conducted using this model showed that the estate tax has roughly the same effect on entrepreneurial incentives as a doubling of income tax rates. In other words, federal income tax rates would need to be nearly twice their current levels to produce the same disincentive as the current estate tax. For example, consider an entrepreneur who is currently paying at the top income tax rate and whose non-corporate business is expected to allow him or her to leave an estate valued at $5.2 million. This estate under current law faces an effective marginal estate tax rate of about 44 percent. To achieve the same degree of disincentive through income taxes it would be necessary to raise the effective individual income tax rate to about 68 percent. According to this research, this pattern of implied income tax rate appears for a wide variety of estate sizes and business growth patterns.

These results indicate that the estate tax creates a powerful influence on some of society's most productive workers, those whose effort has allowed them to create jobs and opportunity for others by

Figure 4
Distribution of Total Estate Wealth by Estate Size
(1989 Estates)



Source: Internal Revenue Service.

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offering goods and services demanded by others in the economy. There is a very good reason why Adam Smith called his famous work on the power of the free market economy to create prosperity: "The Wealth of Nations". The estate tax is a tax on that wealth and, as such, is a direct levy on prosperity.

Since the Super Bowl was played just three days ago, a sports analogy seems appropriate. Imagine a rule that says that for every touchdown scored by an individual player, the team gets six points. And, anytime a player scores more than one touchdown, the team must give up three points at the end of the game per extra touchdown scored. Jerry Rice of the San Francisco 49ers scored three touchdowns in the Super Bowl, giving the 49ers 21 points during the game, counting the extra point kicks. But, if the NFL had a rule similar to the estate tax, at the end of the game the 49ers would have to give back three points each for every touchdown scored after the first, so they would have to give back six points. Under these rules, is Jerry Rice going to try as hard to score that second or third touchdown, particularly since he was playing with a dislocated shoulder? That is what the estate tax looks like to a successful entrepreneur.

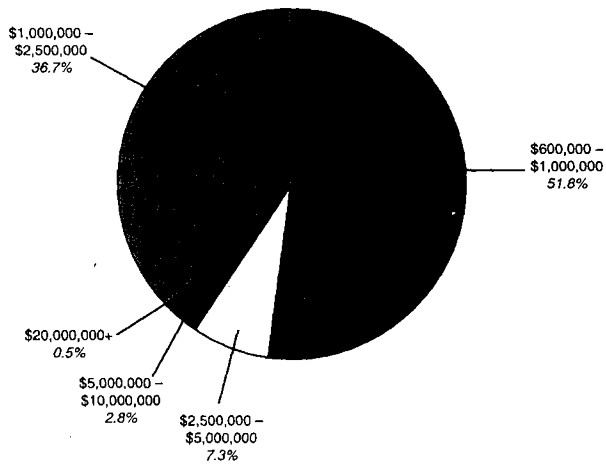
Estate Tax Reform and the Family Business

Estate tax reform that reduces the burden of the tax is a clear statement that society no longer deems the economic cost of the tax, or the unfairness of the tax to the taxpayer, to be a reasonable price to pay for the tax's social policy goals. Such reform may be made in a number of ways. The most simple would be to reduce the tax rates or to increase the amount of the unified credit, and to index all elements of the tax. All of these changes would reduce the economic cost of the tax system.

This cost may also be reduced by targeting the relief towards particular segments of society. For example, it may be suggested that the tax relief would have its greatest effect on reducing economic costs while having the least effect on society's notions of tax fairness by reducing the estate tax burden on the estates of businessmen who started or inherited businesses and developed them into larger, thriving enterprises—what I call first-generation wealth. The supposition inherent in such targeted relief is that society generally is inclined to hold it fairer that an individual who creates wealth through his or her own efforts should be allowed to keep a larger fraction of that wealth than should somebody who inherits wealth.

A narrower policy goal is to reform the estate tax so as to allow family businesses to be inherited by

Figure 5
Distribution of Estate Tax Returns by Size
(1989 Estates)



Source: Tax Foundation.

other family members. The estate tax can impose an enormous financial burden on a family business. Even medium-sized businesses cannot readily access the financial resources necessary to pay the tax, and certainly not without accepting financial burdens that can severely damage the viability of the firm. Consequently, the inheritors of a family business must often sell part or all of the business to outside interests. Targeted estate tax relief could dramatically improve the possibility that a family business could be inherited.

There is an important distinction, however, between a policy that would offer enough relief so that a family business could remain in the family, and relief that is so constraining as to become a policy of requiring that the family business remain in the family in order to qualify for the relief. These constraints may be politically necessary, but the price is less of a reduction of the economic cost of the tax as far as the entrepreneur is concerned in those cases whenever it is not possible or not desired that the business be passed on to other family members. If the intent of the reform is to reduce as far as possible the disincentives facing entrepreneurs in the process of creating first generation wealth, then the relief will have its greatest effects if it comes with the fewest limitations and constraints as possible.

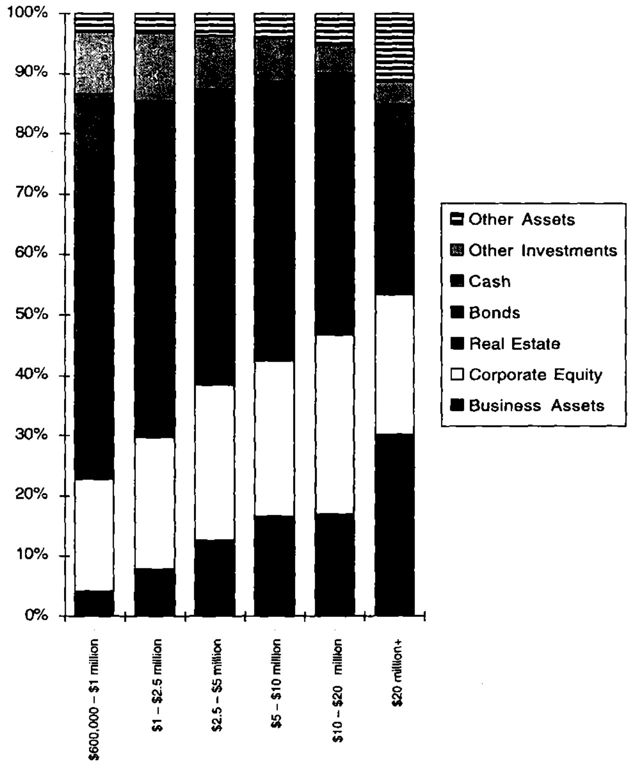
In other words, if the predominant policy goal to be attained in reform of the estate tax is to keep family businesses in the family, then limitations to the reform to that effect are appropriate. However, if the predominant goal is to reduce the disincentives facing the entrepreneur building a successful business, then these limitations can be highly counterproductive. The difference is whether the policy is to make it possible for the family business to continue as such, or to require that it do so to receive the benefits.

Comprehensive Tax Reform and Estate Tax Reform

Comprehensive tax reform is widely anticipated, motivated largely by a recognition that the federal tax system remains harmful to economic growth and international competitiveness, and that its complexity and compliance burdens go far beyond the bounds of reason. There are a number of tax reform plans, both in the Senate and in the House, that have been introduced and that together represent a rough starting point. Whatever their form these plans all have the reduction of the tax burden on saving as a key element. What is little recognized is that these plans all tend to put additional pressure on the estate tax system.

A tax principle likely to undergird any tax reform effort is that all income should be subject to tax once and only once. Since many of the tax reform proposals would only tax income when it is used for consumption, income that is saved and that ultimately becomes part of the individual estate will

Figure 6
Composition of Estates by Estate Size
(1989 Estates)



Source: Internal Revenue Service.

not be subject to tax except through the estate tax. Also, the partial or complete elimination of the tax bias against saving that tax reform promises means that individuals will increase their savings rate. This, in turn, means that estate sizes will be much larger in the future than they would have been without tax reform.

For these reasons, the estate tax is likely to play a far more integral role in the overall federal tax system following tax reform than it does today. Because of the complexity of any comprehensive tax reform effort it is likely that the estate tax would not be given the attention it needs at that time, and so it may be advisable to complete much or all of the desired reform of the estate tax prior to the reform of the federal income tax system.

Conclusion

The federal gift and estate tax lies at the crossroads between redistributionist social policy and economic policies to foster prosperity. The tax poses a tremendous disincentive to work, save, and invest. This disincentive can be acutely felt by entrepreneurs trying to build their businesses.

Estate tax reform may be either general or targeted in nature. If estate tax relief is targeted specifically to reduce the disincentives facing entrepreneurs, then the relief should include as few limitations and constraints as possible because these limitations also limit the effect of the relief. If the relief is intended to allow for businesses to remain in the family, then Congress will need to be careful in deciding between a policy of allowing the business to remain in the family versus a policy of requiring that it remain in the family to qualify for estate tax relief.

APPENDIX: A Model of Estate Taxes and Wealth Accumulation

The model referred to in the above testimony is a mathematical exposition of an individual entrepreneur's wealth accumulation and allocation decision. Because the process of accumulating and allocating wealth occurs over two distinct periods of an individual's life -- working and retirement -- the model is divided into two parts. The first illustrates how wealth is accumulated during an individual's working years. The second part details how a portion of this wealth may be consumed during retirement. Both parts of the model were constructed by combining six equations. These equations describe the following:

(1) The accumulation of wealth over time;

(2) The entrepreneur's total after-income tax income in each period;

(3) The entrepreneur's labor income in each period, which accounts for the disincentive effects of the personal income tax;

(4) A representation of the growth of the entrepreneur's business assets each year;

(5) An expression detailing the entrepreneur's accumulation of equity in the business; and

(6) An expression of the entrepreneur's personal consumption each year.

A short description of each of these equations, as well as a brief explanation of how they are combined is given below. A complete description of the equations and the solution to the model is available from the Tax Foundation.

During an individual's life, wealth will accumulate as income exceeds consumption. This is given by the simple equation:

$$W_j = W_{j-1} + I_j - C_j \tag{1}$$

where wealth at the end of the current year, W_j, is the sum of accumulated wealth from the prior year, W_{j-1}, plus income earned during the current year, I_j, less current year consumption, C_j.

During each year of an individual's life, income is received from any of three sources: (1) labor compensation; (2) the equity which accrues as a result of the growth of business assets; and (3) income from assets held outside the business, which is referred to here simply as interest. All labor income is received from the business and has two components: wages and distributions of equity. Interest is earned on all wealth that is not part of the business. Income is therefore given by the equation:

$$I = f_2[w, D, F, A, t_i, t_c] \tag{2}$$

where income received in any year, I, is the after-tax sum of wages received during that year, w, distributions of equity received that year, D, the interest earned on wealth held outside the business during that year, F, and the equity accrued from the growth of business assets during that year, A. Wage and interest income are assumed to be subject to the individual income tax, t_i. Income generated by the growth of business assets is assumed to be subject to either the individual or corporate income tax, t_c, depending on how the business is structured. If the business is structured as a taxable corporation, equity distributions are assumed to be subject to both the individual and corporate income taxes.

Each year an individual's labor income is given by the expression:

$$L = f_3[t_i, t_c] \tag{3}$$

Recall that an individual's labor income is composed of both wages and equity distributions. As a result, L depends on the individual and, in some cases, the corporate income taxes. To avoid undue complexity, this model does not account for payroll taxes imposed on wage income.

The growth of an entrepreneur's business assets is given by the expression:

$$A = f_4[t_i, t_c] \tag{4}$$

where A depends on the individual and, in some cases, corporate income taxes.

Each year, as the business grows, it generates income. As stated above, this income is subject to taxation by either the individual or corporate income taxes, depending on how the firm is structured. The model also allows the entrepreneur to consume a portion this income. When the firm is structured as a taxable corporation, the after-tax, unconsumed equity, E, that an entrepreneur acquires in any year is given by:

$$E = f_5[A, t_i, t_c, \gamma_1] \tag{5}$$

where E depends on growth of the business, A, the individual and in some cases the corporate income taxes, t_i and t_c, and consumption out of after-tax income generated by the growth of business assets, γ_1.

Individuals may consume out of all components of income. Therefore consumption is given by the expression:

$$C = f_6[w, D, F, A, \gamma_0, \gamma_1, t_i, t_c] \tag{6}$$

The marginal and average propensity to consume out of after-tax wage, dividend, and interest income is γ_0. Consumption out of after-tax income generated from the growth of undistributed business equity is given by γ_1.

The complete model of an entrepreneur's wealth accumulation and allocation decisions is created by combining the five equations described above. An entrepreneur's pattern of wealth accumulation may be mapped out by observing the value of W_j (equation (1)) each year. As stated above, during each year of an individual's career, income, I (expression (2)), is determined by labor income consisting of wages, w, and dividends, D; interest received on wealth held outside the business, F; the growth of business assets, A; and by the individual and corporate income tax rates, t_i and t_c. Labor income earned in any particular year is determined by the specific equation assigned to represent expression (3). The amount of interest bearing wealth held in any year is determined in prior years. The amount of business assets held in any particular year is determined by the specific equation assigned to represent expression (4). Consumption, C_j (expression (5)), during each year of an individual's career is determined by income and by the values assigned to γ_0 and γ_1. During each year of retirement, income is determined by the amount of interest bearing wealth that the individual has accumulated and by the continued growth of the business. Consumption during each year of retirement is assumed to be equal to that in the last year of the individual's career. The model is designed so as to allow for the consideration of a wide variety of income, wealth accumulation, and consumption profiles.

Mr. ENSIGN. Thank you.
Mr. McNutt.

STATEMENT OF LEE WILLIAM MCNUTT, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, COLLIN STREET BAKERY, CORSICANA, TEX., ON BEHALF OF NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MCNUTT. Thank you, Mr. Chairman.

I am Bill McNutt. I am president of the Collin Street Bakery in Corsicana, Tex. Corsicana is a community of 23,000 people, 50 miles south of Dallas, and my company is the primary employer there.

My family's business began with my father going stone broke during the Depression, along with millions of other Americans. He began rising from the ashes in 1933 with an $800 investment in a business in Corsicana from the money that came from my mother's $1,200 inheritance from her just-deceased father who was a small farmer. With the other $400, they invested in a house.

That is a rather humble beginning 62 years ago, but during those years has emerged what is a very successful, small, family-owned enterprise. I think we are typical of the success of American entrepreneurship, combining sometimes really backbreaking work on the part of my father in the early years with a lot of good fortune along the way.

We have grown to a place where now, in the third generation, we have sufficient assets in the company that, upon my death, it will probably have to be sold. In other words, the penalty for success with our death tax rates is just that punitive.

When my father passed away 23 years ago, the company—he had already transferred sums to me in the stock, and the company was not of sufficient value for there to have been an overwhelming estate tax. I got the rest of his stock through my mother before her death last year.

We have enjoyed really tremendous growth during the past 23 years, during which time our foreign sales have grown from zero to 25 percent of our total volume. We are quite proud that we are able to do something about our Nation's disastrous balance of payments and have been awarded the Department of Commerce's Presidential E Award for excellence in exporting.

We are a niche business. We have one product and that is a fruitcake that we market by direct mail only. We market it worldwide. We served over 400,000 customers last year, who ordered our beautiful little fruitcakes primarily as Christmas gifts, by phone, fax and written order.

During these past 23 years the growth cycle—primary growth cycle of our company—we have grown from 24 to 85 full-time employees. They have marvelous jobs. They have fully paid pension plans. They have a 401(k) plan that we match dollar for dollar. They have full health coverage. We really do not know how to be a better employer than we are.

I have steadfastly refused to let the company be sold into larger hands—and we have rather frequent opportunities—because I am convinced that we can best serve our customers and our employees and ourselves by remaining staunchly independent. Because if some giant corporation were to take over our operation and see the way we operate, they would first think we were crazy, but they would alter the company, I am convinced, beyond recognition, to the point where in a few years it very well might not exist.

The second and primary reason for not wanting to sell the company is my wish to pass it along to my children—two sons and two daughters. My heir apparent is a 38-year-old young man who started to work at the bakery summers when he was 11 and 12 years old. I would take him to work for me at 8 o'clock in the morning, and he would sweep the curbs, go home for lunch and have the afternoons free. Very typical, I expect, of the way many fathers have brought their sons into the business.

He has worked in every department. He is very able, and he is ready to take over our enterprise. And nearing 70 years of age and after 37 years with the company, I am about ready to pass the baton.

But under current estate laws I fear that the baton will be passed on only temporarily because at the death of myself and my wife there is no way the money is going to be there to pay the estate taxes.

We have bought insurance to the extent that it is realistic. Well over half my assets are in our family-owned business. It may very well have to go under the hammer.

I have written memorandums to my children and told them on the death of their mother and myself that they are to sell every asset, everything that we own, everything that my wife and I have accumulated through our lifetime. I recommend: If you want to keep the Collin Street Bakery, you sell it off, sell the kitchen sink, sell the home, sell your mother's jewelry, sell the art. If it has a dollar value, you sell it, and it might bring you enough money, combined with a substantial bank loan, to allow you to keep our company. That is how punitive the tax rate is on a small family held business.

Mr. ENSIGN. Mr. McNutt, if can you wrap it up. Your 5 minutes is up. Can you wrap it up real quick?

Mr. MCNUTT. All right.

The gentleman who said the power to tax is the power to destroy could not have been more foresighted than he was. And you people on this committee particularly have the opportunity to reverse a 40-year trend toward socialism and redistribution of the wealth in this country and return us to the track of capitalism and free enterprise.

We pray your success. We urge your attention to the elimination of small businesses from estate tax laws so they can continue to operate within families.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

Witness: Lee William McNutt, Jr.
President / CEO, Collin Street Bakery
Corsicana, TX

Subject: Impact of the Estate Tax on Small Business

Before: House Committee on Small Business

Date: January 31, 1995

The National Federation of Independent Business appreciates the opportunity to submit testimony on the issue of estate taxes and their impact on small businesses. NFIB is the nation's largest small business organization representing over 600,000 small business owners from all fifty states. NFIB sets its public policy positions through regular polling of the membership.

Costs of the Estate Tax

The process the Committee and the Congress is now engaged in presents an historic opportunity to relieve America's small business owners from government-imposed burdens and to open the door to economic expansion and job creation in the small business sector. The federal estate tax represents perhaps the greatest burden today on our nation's most successful small businesses.

At roughly one percent of annual revenues, this tax is hardly worth the devastation it causes to family businesses and farms, entrepreneurship, and our nation's international competitiveness. The costs of such damage to small businesses and our nation's economy is unquestionably high.

Small Business: America's Path to Jobs and Independence

Evidence continues to suggest clearly that small business plays a rather remarkable role as a job creator and provider of personal opportunity, security and independence for millions of Americans. Consider the following:

Jobs. Since the early 1970s, small firms have created two of every three net new jobs in this country (created jobs minus lost jobs). The nation's small business job machine has shown a capacity to produce in either good or tough times. From 1989 to 1991, a period of minimal economic growth, firms with fewer than 20 employees created virtually all net new jobs in the country.

Demographics. Almost all businesses are small businesses. There are approximately five million employers in the United States. About 99 percent of them are small employers. Small business as a whole employs more than half of the private sector workforce. Most small firms are not set up as C Corporations, but as proprietorships, partnerships, and subchapter S corporations.

Values. Small business holds out to our citizens great hope. Small business offers a road map to the American dream that allows any American with a good idea and talent to follow it to economic freedom and security by starting their own business and working hard to make it a success. And possibly the ultimate American dream is to be able to pass that successful business on to one's children.

Evidence indicates that the vast majority of America's small closely-held businesses are family businesses. Although it is difficult to precisely define a "family business", there are clear characteristics of the family business which distinguish it from others. While other businesses are usually driven entirely by return on investment, the family business is most often driven first by other priorities -- like relationships and longevity. Family businesses are generally much smaller than publicly-traded corporations, but possess certain advantages over these larger businesses. For instance, being private, family businesses do not have to worry about quarterly earnings reports for stock analysis, and can instead focus on long-term value enhancement, even if it means losing money in the short-term in some cases. Additionally, family businesses operate without a rigid bureaucracy, consequently, they can respond quickly and intuitively to changes in business environments. On the other hand, because of personal considerations, such as a desire to pass the business on to one's children, a family business may not always make purely rational decisions in a market-driven sense. Family businesses play a far greater role in this nation's economy than many might think -- estimates indicate that they produce roughly half of our nation's gross domestic product.

The Need for Estate Tax Reform

NFIB considers estate tax reform to be crucial to the continued survival of the small American family business. Current estate tax rates cripple a small business passed on to heirs, and often force them to liquidate a business they have worked in their whole lives. High estate taxes may provide government revenue in the short run, but the long-run losses far outweigh the gains -- a productive business is extinguished, many jobs are lost, and the American dream of growing a business and preserving it beyond one's lifetime by passing it on to heirs becomes impossible to achieve.

Because all assets are included in determining estate tax calculations, such as the decedent's home and other personal assets, many productive businesses worth far less than the current exemption level become victims of the estate tax. Because so many small businesses operate on cash flow, often with extremely small or negative profit margins, current law allowing small businesses to spread their tax liability over ten years does not provide adequate relief.

Small businesses are also particularly vulnerable to the intricacies of estate tax law. Although some owners can ensure a successful transfer to heirs by purchasing life insurance and through other methods, many cannot afford this kind of planning or do not have the time to meet with estate planners because most of their energies are directed toward keeping the business running. Unfortunately, unlike a publicly traded corporation which continues operation regardless of how shareholders plan for their death, a closely held business, unless there has been careful planning, is usually devastated by the death of an owner.

Impact on Small Business

Current estate tax rates range from 37 to 55 percent. Faced with the tremendous burden imposed by this tax upon their death, a business owner will react in several of the following ways:

1) **The business owner will not expand the business.** Especially in later years of the business owner's life, large capital expenditures for long term growth make little sense when the family will soon be forced to sell or liquidate the business. This disincentive to growth means lost opportunities, lower productivity, and lost jobs. In fact, the existence of estate taxes can deter many potential entrepreneurs from starting a business at all.

2) **The children will not participate in the business.** Knowing that taxes will prevent children from continuing operation of a family business, the business owner will often discourage their children from working in the business and encourage them to gain experience elsewhere. If the children do actively participate in the business, their experience and knowledge will often go to waste when the business is forced to be sold off. A recent survey of family businesses by Mass Mutual Life Insurance showed that only 57 percent of owners planned on keeping the business in the family, down from 65 percent a year ago; taxes were cited as one of the prime reasons for plans to sell out.

3) **The business owner will pay dearly in estate planning costs.** Even if the business owner has the foresight to plan early for their death, the expense of this planning, in insurance, legal and accounting costs, can be enough to eliminate a business' small profit margin. These extra insurance, legal and accounting costs are especially burdensome because small businesses survive on cash flow, not profit. In the NFIB Education Foundation's survey entitled Small Business *Problems and Priorities*, cash flow ranked as the third highest problem for small business, behind only the cost of health insurance and federal taxation. Coming up with the cash to pay bills and make payroll is a constant challenge in a small firm. Money left in the business -- cash flow -- is the difference between life and death for most new businesses. The costs to small business and society as a whole are high -- instead of using these funds to expand, create

new jobs, and become more productive and competitive in the international marketplace, small businesses must spend the money on estate planning costs.

4) **Heirs may not be able to afford tax payments.** Despite some planning, heirs are often still imposed with some significant tax burden. Even paid out over time, taxes may be too much of a burden to survive in an internationally competitive marketplace.

__Fire-Sale of the Family Business__

What this means is that all too often the family business is sold-off, either before the owner's death or by the estate. Most often, a ready market does not exist for the sale of a small family run business. Consequently, the business is subject to a fire-sale -- either liquidated entirely or sold intact for a price far below its true value. Additionally, much of the value of a family business often comes from the experience and know-how of those who run it -- the family members. Their stewardship often makes the difference between a profitable, successful business enterprise, and a dying one.

All too often, the family business or farm will be bought-up by a large business such as a corporate conglomerate at a price that's a fraction of the real value of the business. While the large business may gain some of the assets of the small business, most of the real value of the former business is lost -- the entrepreneurial spirit, know-how and ingenuity, the small business' flexibility and usually most if not all of the jobs. What might have become an Apple computer instead becomes another division of a large cash register sales company.

Contrast this with what happens when a shareholder in a corporation traded on the New York Stock Exchange dies. Because there is a ready market for the stock, the estate can easily sell off enough to pay taxes. The value of that stock does not decline because of the sale. Although the stock may have new owners, the operation of the corporation continues completely unaffected by the shareholder's death.

__Public Policy Reasons for the Estate Tax ?__

The philosophy behind the estate tax started with early Americans who were trying to prevent the pooling of too much wealth in too few families, as had occurred in Europe. Today, however, this philosophy is fundamentally flawed. When applied to closely-held business assets, ironically, the tax produces just the opposite result -- often forcing family-owned businesses to sell-off to larger public corporations, further concentrating the wealth and power of this country and encouraging monopolistic controls of markets. This philosophy also ignores the tax's impact on communities that are dependent on these businesses, and its deleterious impact on our nation's international competitiveness against foreign countries like Japan and Germany who do not impose this kind of estate tax burden and who encourage the continuation of family-run enterprises.

NFIB Estate Tax Reform Proposal

NFIB strongly supports the Contract with America's Job Creation and Wage Enhancement Act proposal to raise the estate tax exemption from $600,000 to $750,000, and to index the exemption to inflation. It is a very needed first step. **We further propose that the value of closely-held business, farm and ranch assets in an estate be exempted from estate taxes altogether.**

Exempting closely-held business, farm and ranch assets from estate taxes would ensure that the business will continue and that the jobs of its employees will be protected. Moreover, this exemption would eliminate the strong disincentive that now exists for business owners to continue to develop their business and create jobs as they reach their later years in life. A recent study by the Tax Foundation found that today's estate tax rates have the same disincentive effect on entrepreneurs as a doubling of current income tax rate.

Total federal estate tax revenue represents only about $12 billion annually. Business assets represent roughly 12 percent of this $12 billion -- about $1.4 billion a year. **In other words, for $1.4 billion annually every closely-held farm, ranch, and small business in America could be exempt from the federal tax collector's axe.**

To ensure this exemption would be appropriately targeted to family businesses and farms that need it, the NFIB proposal would apply the exemption only to closely-held businesses that constitute a major portion of the decedent's estate, such that liquid assets are not available to allow the business to remain intact. Further, heirs would have to continue operation of the business for at least ten years, or some of the estate tax would be recaptured on a pro-rata basis. Finally, to prevent abuse, the proposal would exempt from estate taxes only those assets necessary for the active operation of the business.

By restoring incentives to continue operation of closely-held businesses in the family, this proposal would fuel economic growth in the sector which produces more than half of our nation's gross domestic product. Any loss of revenue by static analysis would likely be more than compensated by a greater tax base in the small business sector.

Conclusion

Current estate tax rates impose an often overwhelming burden on our nation's small family-run businesses. The small amount of revenue this tax generates is hardly worth the long term damage impacted on these enterprises -- in the long run the tax means less economic activity, job loss, and prevention of the continuation and fulfillment of the American dream of operating one's own business and passing it on to one's children.

Exempting business assets from estate taxation would remove the single greatest government burden imposed upon small family businesses, setting national priorities where they should be: encouraging the continued operation and expansion of family businesses through generations.

Mr. ENSIGN. Thank you for your testimony.
Mr. Turner.

STATEMENT OF JIM TURNER, CHAIRMAN, ESTATE AND GIFT TAX SUBCOMMITTEE; VICE CHAIRMAN, TAX AND CREDIT COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION; AND A RANCHER, SARASOTA, FLA.

Mr. TURNER. Mr. Chairman and members of the committee, thank you for your concern about the estate tax impact on farmers, ranchers and other family businessowners. The National Cattlemen's Association appreciates the opportunity to discuss these issues with you today.

I am Jim Turner. I am vice chairman of the tax and credit committee of the National Cattlemen's Association; and, as such, I chair that committee's estate and gift tax subcommittee. I am also a practicing real estate and tax attorney and have done some estate tax work for families in agriculture.

Our family has owned a cattle and citrus enterprise in Sarasota County, Fla., for the last 50 years or so. My late father, Latimer H. Turner, is a past chairman of the tax and credit committee of the NCA and a past president of the Florida Cattlemen's Association.

One of the National Cattlemen's Association's top priorities this year—and, indeed, for many of the last several years—is estate tax reform. As Congressman Barrett testified earlier this morning, the average age of cattlemen in this country is now 55 years old. That statistic suggests that there are currently a lot of senior family members owning ranches whose families will soon face the burden of Federal estate taxes. The number of cattle operations in this country has declined 20 percent from 1981 to 1993, to the lowest level of the century. The impending burden of Federal estate taxes, we believe, is only likely to accelerate that trend.

We feel the burden of estate taxes has contributed to families selling their family farming and ranching enterprises, resulting in the concentration of these enterprises in fewer and fewer hands. This concentration, we feel, is leading to the deterioration of rural America.

The estate tax was implemented, as I understand it, out of some populist notion that the estate tax would prevent an accumulation of wealth in a few privileged hands. However, we believe it has done just the opposite. The estate tax has caused further concentration of ownership because when families have to liquidate their operations to fund estate taxes, the only buyers with enough capital to buy are large, publicly owned corporations. Family-owned businesses are spending what capital they have trying to plan around estate taxes, not planning to expand.

My written comments recommend a number of amendments to estate tax laws to soften their impact. However, we feel even more needs to be done. The estate tax acts as a huge drag on the retention and expansion of family-owned businesses. It provides a disincentive to savings and stifles the type of capital investment which could lead to higher productivity and more and better jobs.

A tax with a rate as high as 55 percent imposed on death, an event that no one has very much control over, when the family business may not have the liquidity to pay the tax, is such a frightening thought that families spend an inordinate amount of time and resources planning around estate taxes rather than planning for growth and increased productivity.

The liquidity problem is what distinguishes family-owned businesses from estates of individuals holding marketable securities and other liquid assets. Coupon clippers can easily liquidate their holdings to pay estate taxes, but most family-owned businesses cannot.

Our family is a case in point. My grandfather bought our ranch in the early forties. The growth in southwest Florida has enhanced property values in our area. My father and uncle borrowed a large sum of money to buy my grandfather out over 20 years ago out of fear for the growing estate tax problem in my grandfather's estate. The resulting debt service has been a drain on our operation ever since. Our operation is already being taxed, you see, in a sense, to plan for estate taxes.

With the death of my father a couple of years ago, we are scared to death—or should I say we are scared of death. Our family is now buying life insurance on the lives of my mother and uncle to provide some liquidity to pay estate taxes on their deaths. This is additional money that could have been used to expand our operations that is now going toward estate tax planning. The sad fact is, despite all our planning, we will have to sell a substantial portion of our ranch to pay estate taxes when my mother dies.

The unified credit and section 2032A benefits are not big enough. The operation will not cover the debt service on section 6166's estate tax installment payments. We cannot afford to buy enough life insurance, and we cannot gift it away fast enough.

Furthermore, the buyer from my mother's estate will quickly grow houses, not cattle and oranges. My brother, who now runs our cattle operation, will be out of a job.

This is why my father encouraged me not to get into agriculture but into some service profession, knowing that estate taxes would take away our future in agriculture. This will also be a loss to the environment. Our operation was awarded the NCA's Environmental Stewardship Award for the State of Florida 2 years ago. We love and care for our land the way only long-term owners of land can love it.

The environment in our area would benefit from allowing families like ourselves to continue to own and ranch our land, rather than forcing us to sell it prematurely to develop it to pay estate taxes.

There is a proposal supported by a number of business groups, including the NCA, designed to reduce the estate tax burden on farmers and other businessowners. This proposal, which we hope will be introduced soon, is similar to H.R. 5032, the Family Preservation Act sponsored by Congressmen Brewster, McCrery and others in the 103d Congress.

This would be a strong incentive for successful entrepreneurs, including cattlemen, to keep working and creating jobs rather than selling out to others. It eliminates the estate tax for estates holding 50 percent or more of assets in family-owned businesses.

We urge your serious consideration of these proposals and, in the meantime, consideration of the amendments to existing law we have suggested in our written comments.

Thank you for the opportunity to speak to you.

[The prepared statement follows:]

TESTIMONY OF JIM TURNER
NATIONAL CATTLEMEN'S ASSOCIATION

Mr. Chairman, Mr. Gibbons, members of the House Ways and Means Committee, thank you for your concern about the estate tax impact on farmers, ranchers, and other family-owned businesses. The National Cattlemen's Association appreciates the opportunity to discuss these issues.

I am Vice-Chairman of the Tax and Credit Committee of the National Cattlemen's Association and Chairman of the Estate and Gift Tax Subcommittee. I am a cattlemen and a practicing attorney, concentrating on real estate and tax matters. While my tax background primarily involves real estate, corporate and partnership matters, I have done some estate tax work as well, particularly for families in agriculture. Our family has owned a cattle and citrus enterprise in Sarasota County, Florida, for the past 50 years or so. My father, Latimer H. Turner, who is now deceased, was a past chairman on NCA's Tax and Credit Committee and a past-President of the Florida Cattlemen's Association.

One of the National Cattlemen's Association's top priorities for the coming year is estate tax reform. Indeed, estate taxes have been a priority issue for the NCA for many years. Currently, 80% of beef cattle operations have remained in one family for 25 years or more, with 42% over 50 years, and 12% more than 100 years. Surveys indicate the average age of cattlemen is now 55 years. Those statistics suggest that there are currently a lot of senior family members owning ranches whose families will soon face the burden of federal estate taxation. The number of cattle operations has declined 20% from 1981 to 1993, to the lowest level of the century. The impending burden of federal estate taxes is likely to only accelerate that trend.

We feel the burden of estate taxes has contributed to families selling their family farming and ranching enterprises, resulting in the concentration of these enterprises in fewer and fewer hands. This concentration is contributing to the deterioration of rural America. Therefore, the NCA supports a number of proposals for modification of the federal estate and gift tax laws which would benefit farmers, ranchers, and other family business owners.

I will discuss several changes we support. We urge you to take this historic opportunity provided by the recent elections and fundamentally change estate tax laws as they apply to family businesses.

The NCA applauds your efforts in introducing the Jobs Creation and Wage Enhancement Act of 1995 (H.R. 9) which contains the provision to increase the Unified Estate and Gift Tax Credit to $750,000 and index the amount thereafter. Inflation has eroded the benefit of the current $600,000 Unified Credit Equivalent limit just as the benefit limit on Section 2032A has been eroded over the last several years, as discussed above.

The NCA encourages a re-examination of the entire estate and gift tax structure, and its impact on family owned businesses. There is a proposal supported by a number of business groups, including our organization, designed to reduce the estate tax burden on farmers, ranchers, and other family-owned businesses. This proposal, which we hope will be introduced soon, is similar to H.R. 5032, the Family Preservation Act, sponsored by Congressmen Brewster, McCrery and others in the 103rd Congress, would eliminate the estate tax liability on family business assets when at least half the value of the estate is a family owned business. It contains several qualifications to prevent abuse. This is a strong incentive for successful entrepreneurs, including cattlemen, to keep working and creating jobs, rather than selling out to others. A June 2, 1994 study of the Tax Foundation concluded that estate tax laws can have roughly the same disincentive effects on entrepreneurial activity as a doubling of income tax rates. Such a burden cannot stand.

If the estates of farmers and ranchers are required to sell their agricultural holdings to pay estate taxes, particularly in our area of southwest Florida, the land will most likely be sold to corporate or foreign agricultural interests or to development interests and the development process will be accelerated. The members of the NCA know their land, they love their land and they have been good stewards. Most of the ranchers in our area want to stay in agriculture. The environment would benefit from leaving these lands as open space and in the hands of the current owners. However, the burden of estate taxes as currently imposed may take this decision away from them.

As mentioned earlier, several of the business groups that the NCA works with have listed estate tax reform as a priority issue, including the Independent Bankers Association of America, the American Farm Bureau Federation, National Small Business United, Small Business Legislative Counsel, the National Federation of Independent Businesses, and many more. The White House Conference on Small Business is currently holding conferences around the country in preparation for the national conference on June 11 through 15, 1995. We will use this forum to discuss and promote estate tax reform for family-owned businesses.

Cattlemen were actively involved in the initial discussions of Section 2032A, *Special Use Valuation*, which allows farmers and ranchers to value their property based on productive values rather than market value for estate tax purposes. We strongly support this very useful estate tax tool and request that the following changes be considered in the 104th Congress.

The maximum amount an estate can be reduced by electing Special Use Valuation pursuant to Section 2032A has been fixed for the past several years at $750,000 (for decedents dying on or after January 1, 1983). Therefore, the benefit of this reduction in estate tax valuation available to farmers and ranchers has been eroded. Congressmen Bill Thomas from California has introduced H.R. 520 to double the 2032A valuation limit from $750,000 to $1,500,000. Congressman Wally Herger from California has introduced H. R. 532, which indexes the $750,000 valuation limit. We applaud their efforts and support both of these bills.

Section 2032A, in addition to Internal Revenue Code Section 6166 (*Installment Payment of Estate Taxes*) both require recapture of the benefits provided by those sections if the farmland is cash-leased after death, even to a relative. We believe that a cash lease to a relative satisfies the public policy goal of keeping farmland "within the family" after death. Therefore, Sections 2032A and 6166 should both be amended to allow farmland to be cash-leased to a relative after death without requiring a recapture of the benefits under 2032A and 6166. This idea has been endorsed by a number of Representatives and Senators over the years and has been introduced in various forms through several packages of legislation, but has not yet passed. Senator Kassebaum of Kansas and the then-Chairman of the Senate Finance Committee Bentsen of Texas engaged in a colloquy on the record March 13, 1992, suggesting that they would offer such an amendment in the anticipated Technical Corrections Legislation that year and encourage the Department of the Treasury and the Internal Revenue Service to suspend action in this area until Congress had the opportunity to correct this technical problem. However, the Internal Revenue Service and the Treasury have not withdrawn from this issue; they are still litigating it.

On a related matter, Section 6166 (*Installment Payment of Estate Taxes*) is often used in tandem with the special use valuations provisions of Section 2032A. Section 2032A allows property to be considered qualified if it is used and held for use as a farm or other closely-held business by the decedent <u>or a member of his family</u> such that a cash lease by the decedent to his family prior to death would qualify. However, for the purposes of Section 6166, farmland leased on a cash basis prior to death, <u>even to a relative</u> or to an entity owned by the same individuals as own the land, will not qualify as a closely-held business under Section 6166. Therefore, Section 6166 should be amended to conform with Section 2032A.

Furthermore, the Treasury Regulations under 2032A currently require compliance with a lot of detailed filing procedures for a farmer or rancher to be entitled to the benefits of Section 2032A. The regulations allow an estate the opportunity to cure procedural defects only if the original filing substantially complies with the regulations. There has been a lot of litigation over the question of the circumstances under which an executor has "substantially complied." We believe an executor should be allowed to supply any missing information within a reasonable period of time (not to exceed 90 days) after notification by the I.R.S. of a procedural deficiency without regard to the question whether the original filing "substantially complied" with the regulations. The current interpretation of substantial compliance, which is limiting, has resulted in hardship and, we feel, unintended results. A provision clarifying substantial compliance has been contained in Tax Simplification bills introduced by this Committee and the Senate Finance Committee each year for the past several years. We appreciate your support for that legislation, and would urge the "substantial compliance" provision dealing with Section 2032A be reintroduced and passed in the 104th Congress.

Congress needs to retroactively invalidate the effective regulations Section 20.2032A-8(a)(2), which was deemed to be invalid by the court in <u>Estate of Miller v. U.S.A.</u> (U.S. Dist. Ct. for Central Dist. Illinois, March 9, 1988) 88-USTC ¶13,757, thereby making clear that Section 2032A of the Internal Revenue Code does not require a 2032A election as to 25 percent of the estate, but merely requires that 25 percent of the estate qualify for the election. I am enclosing a memorandum to the NCA's Tax and Credit Committee from me dated November 22, 1991 which further explains this issue.

Another problem with the regulations under 2032A is the requirement that every heir holding an interest in an estate, no matter how small, how contingent, or how remote, must sign the recapture agreement pursuant to the benefits of Section 2032A if the farmland is disposed of within ten years of the date of death of the decedent. There ought to be some provision pursuant to which the holders of small contingent interests, such as that actuarially valued as equal to or less than two percent of the total, do not have to sign the recapture agreement. The federal tax lien created by the Code on the subject farmland would be sufficient to enforce the Treasury's recapture rights under 2032A if the property was sold within the ten-year period.

Another issue that has become relevant in an estate in family-business estate that I am handling has to do with the full payment requirement which is a jurisdictional prerequisites to having a tax controversy heard in our federal district courts. The facts are as follows. A member of a family which owned a closely-held business died and the decedent's closely-held business interest was included in the estate. The estate qualified for Section 6166 installment payment of estate tax and made that election. The I.R.S. audited the estate and challenged the valuation of the closely-held business interests reported in the estate tax return. A deficiency letter was issued and our client was faced with the options of paying the amount of the deficiency and seeking a refund in the federal district court, which requires prepayment of the amount of the deficiency, or petitioning the tax court for review. For a variety of reasons, we would have preferred to go to the federal district court. However, the full payment rule would not only have dictated that our client prepay the full amount of deficiency in order to have jurisdiction to go to the federal district court, but our client would also have had to prepay the amount of taxed the estate admitted were due and owing but which had been deferred pursuant to Section 6166. The burden of borrowing the amount of the deficiency to prepay that amount together with borrowing the amount that had otherwise been legitimately deferred pursuant to Section 6166 was overwhelming, leaving our client no other choice but to go to the tax court. This situation needs to be changed. The full payment rule needs to be modified such that estates do not have to prepay the amount of taxes admittedly owing and deferred under Section 6166 but only have to prepay the amount of the deficiency in order to have jurisdiction to go to the federal district court. This proposal was endorsed by the House of Delegates of the American Bar Association in a vote taken August 12, 1992 (Resolution 101A) after a presentation by the ABA Section of Taxation.

Another issue that has popped up in the same estate in a Section 6166 context is as follows. Interest paid pursuant to a 6166 installment election to pay estate taxes is deductible against the taxable estate as an administration expense. However, the estate has the option to deduct the interest for income tax purposes, rather than deducting it against the value of the taxable estate for estate tax purposes. If it chooses to treat the 6166 interest as deductible for federal income tax purposes, the question arises whether the interest will be deductible or will be nondeductible "personal" interest. Section

163(h)(2)(E), added by the Tax Reform Act of 1986, provided that interest paid under Section 6166 on the deferral of estate tax continues to be deductible and is not considered to be "personal interest" under the general rule of Section 163(h), Internal Revenue Code. However, there is no similar authority providing that the interest paid pursuant to a commercial loan borrowed to pay federal estate taxes is deductible for federal income tax purposes. Interest on monies borrowed to pay federal estate tax purposes should be deductible either from the taxable estate as an administration expense (which is currently the law) or should be deductible for federal income tax purposes and not characterized as "personal" interest, regardless of whether the lender is the government pursuant to Section 6166 or whether the lender is a commercial lending institution. Interest on monies borrowed to pay federal estate taxes attributable to an interest in a closely-held business should not be considered to be "personal" interest, but should be deductible as a business expense, passive interest or investment interest, depending on the nature of the enterprise owned by the decedent.

Once again, I appreciate the opportunity to speak to this Committee. Thank you.

Mr. ENSIGN. Thank you.
Mr. Lange.

STATEMENT OF ROBERT T. LANGE, OPERATOR, WILLISBROOK FARM, MALVERN, PA.

Mr. LANGE. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to testify in front of you today.

My name is Robert Lange, and I am a full-time farmer from Malvern, Pa. And Malvern is 24 miles west of Philadelphia, so we are in the southeast corner of the State of Pennsylvania.

Our farm is currently owned by my grandmother, who is 93 years old, and our farm has been in our family since 1896. I am here to testify today about a problem that is facing many farm families such as ourselves in the attempt to pass that farm from one generation down to the next generation, and that is what I perceive as an unintended impact of the Federal estate tax.

Our farm is 226 acres. I farm 100 acres of corn, 100 acres of soybeans, wheat, hay. In addition to that, I grow five acres of pick-your-own strawberries, five acres of pick-your-own pumpkins, vegetables, corn.

The proximity to Philadelphia is a blessing, and it is a curse. It is a blessing in that we have unlimited potential customers who come out to pick my produce. The curse is that, being close to an urban area, our fair market value of our land is astronomical. It is anywhere from 10 to 20 times the average farmland value in Pennsylvania.

Most heirs cannot afford the estate tax bill when the farm is valued in this manner. Even taking full advantage of the limited relief provisions in the tax law, including the unified credit and the deduction for donation of qualified conservation easements, farm families typically do not have the liquid assets to pay the estate tax of as much as 55 percent. Thus, the heirs are forced to sell a large portion of their farm just to pay these estate taxes off.

I believe the problem created by this manner of valuation is a unique problem for farm families. Most closely held businesses are valued for tax purposes under a formula that at least takes into account the receipts generated by the type of business undertaken. In the case of farms, on the other hand, the farm business is valued by looking at what the property could generate if it were used for the purpose other than farming, such as commercial development.

I do not believe that Congress would have intended the estate tax laws to force the sale of family farms in the United States in this manner. The special valuation rules for farmland contained in the Internal Revenue Code, section 2032A, appear intended to prevent this very result. However, the complexity of this section makes it very difficult for most farm families to understand or use. Moreover, the breakup of the family farms to pay estate taxes undermines the goals set forth in the U.S. farm policy—the protection of agriculture resources in the United States.

When I realized this problem back in 1988, I contacted my Congressman at the time, Richard Schulze. Mr. Schulze came out in the fall of 1988 and listened to our family's problem about the estate tax. The following year, he introduced legislation that would help us and other farm families. This legislation was reintroduced with some modifications in the last Congress by Congressman Payne, and I want to tell you I really appreciate your keeping the issue on the front burner and giving us a shot at this.

This session, I understand Congressman Houghton will introduce and Congressman Payne will cosponsor the bill that we have been working hard on since 1988. And the solution contained in that bill and the one we seek today simply is to exclude from the estate certain farmland protected by a perpetual conservation easement. Such a provision would achieve two different goals: It would save your agricultural resources, and it would give the ability to farm families to withstand an excessive estate tax burden and be able to pass that farm down to the next generation.

In addition, the American Farm Protection Act would provide valuable incentive for voluntary conservation easements on rural lands. Our country is losing over 4 square miles of farmland every day. That is over 1,200 acres—or over 2,400 acres, excuse me. This bill would also provide a tool to conserve the land for agricultural purposes without heavyhanded government regulation and without taking the property off the tax rolls.

Mr. Chairman and members, I am not a lobbyist. I am a farmer that simply wants to continue farming my family farm as long as I can. We have done everything under current legislation, in terms of the estate tax and the gift tax laws, that we can to make that happen. Without this legislation we and other farm families across the country will not be able to hold on to the family farm. I urge this committee to include the provisions of the American Farm Protection Act in any tax legislation you approve.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT T. LANGE, FARMER
MALVERN, PENNSYLVANIA
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WEDNESDAY, FEBRUARY 1, 1995

My name is Robert Lange. I am a full-time farmer from just outside Malvern, Pennsylvania, 24 miles west of Philadelphia in Chester County, Pennsylvania. My grandmother, who is 93, currently owns our farm, which has been in our family since 1896. I am here to testify today about a problem that many farm families are facing as the older generation attempts to pass the family farm on to the younger generation who want to continue to farm it, and that is the perverse and I believe unintended impact of the federal estate tax.

Our farm is 226 acres. It is an active, working farm. We grow everything from corn to strawberries and pumpkins. Our proximity to Philadelphia is both a blessing and a curse. Because we sell much of our produce to customers that "pick their own" fruits and vegetables, we need to be relatively close to major population areas. However, our location near an urban area means that the fair market value of our farmland is anywhere from 10 to 20 times higher than typical farmland in Pennsylvania.[1] This is because the fair market value means the value of the land when developed for residential or commercial purposes, not the value at its current farm use. This is crucial because when the owner of the farm dies, the federal estate tax law requires that the fair market value of the farm, that is, its value as developed land rather than farmland, be included in the owner's estate.

Most heirs cannot afford the estate tax bill when the farm is valued in this manner. Even taking full advantage of the limited relief provisions in the tax law, including the unified credit and the deduction for the donation of qualified conservation easements, farm families typically do not have the liquid assets to pay an estate tax of as much as 55 percent of the estate's value. Thus, the heirs are forced to sell some or large portions of the farm just to pay off the federal estate tax. Sale of even a portion of the farm may make the remainder uneconomical as a farming unit.

I believe the problem created by this manner of valuation is a unique problem for farm families. Most closely-held businesses are valued for tax purposes under a formula that at least takes into account the receipts generated by the type of business undertaken. In the case of farms, on the other hand, the farm business is valued by looking at what the property could generate if it were used for a purpose other than farming, such as commercial development.

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[1] Typical farmland in Pennsylvania is valued somewhere between $2000 and $4000 per acre. Farmland close to an urban area, such as mine, is valued between $20,000 and $40,000 per acre.

I do not believe that Congress could have intended the estate tax laws to force the sale of family farms in the United States in this manner. To force the break-up of family farms to pay estate taxes is inconsistent with other relief provisions in the tax laws which attempt to protect family farms. The special valuation rules for farmland contained in Internal Revenue Code section 2032A appear intended to prevent this very result. However, the complexity of the section makes it very difficult for most farm families to understand or use.[2] Moreover, the breakup of family farms to pay estate taxes undermines the goal set forth in U.S. farm policy, the protection of agricultural resources in the United States.

When I realized the difficulties the estate tax laws would create in my own situation, I brought this problem to the attention of my own Congressman at the time, Richard Schulze. He came out to the farm and listened to our problem. The following year he introduced legislation to address our problem and that of other farm families. This legislation was reintroduced with some modifications as H.R.2031 last Congress by Congressman Payne. The solution contained in that bill and the one we seek today is simply to exclude from the estate certain farmland protected by a perpetual easement. Such a provision would achieve the dual goals of protecting the agricultural resources of this country and easing the inequitable tax burden of families who seek to continue farming.

In addition, the American Farm Protection Act would provide a valuable incentive for voluntary conservation of rural land. Our country is losing over 4 square miles of farmland daily to development. This bill would provide a tool to conserve this land for agricultural and other compatible purposes without heavy-handed government regulation, and without taking the property off the local tax rolls.

Mr. Chairman and Members of this Committee, I am not a lobbyist. I am a farmer who wants to go on farming my family's property for as long as I can. My family and I have done everything we can under present estate and gift tax laws to reduce the potential estate tax to a level that will enable us to retain our family farm when the time comes. Even an increase in the unified credit, which I support, as proposed in the Republican Contract, is not enough. Without this legislation, we and other farm families across the country, will not be able to hold on to the family's farm. I urge this Committee to include the provisions of the American Farm Protection Act in any tax legislation you approve.

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[2] Unfortunately, these special rules have not been greatly utilized by farm families primarily because of their complexity, but also because of the cap on the amount by which the value of the estate can be reduced. See, Report of the Comptroller General, Special Estate Tax Provisions for Farmers Should Be Simplified to Achieve Fair Distribution of Benefits. September 30, 1981, PAD-81-68.

Mr. ENSIGN. Thank you, Mr. Lange.
Mr. Thigpen.

STATEMENT OF CHESTER A. THIGPEN, CERTIFIED TREE FARMER, MONTROSE, MISS., ON BEHALF OF THE AMERICAN TREE FARM SYSTEM

Mr. THIGPEN. My name is Chester Thigpen. My wife, Rosett, and I are tree farmers from Montrose, Miss. Mr. Chairman, I appreciate the opportunity to appear before this committee. I have submitted a written statement, and I would like to summarize it for you now.

The issue you are debating is very important to the Nation's 7 million productive landowners. Research tells us that perhaps half of those folks are 62 years old or older, so it should come as no surprise to the committee that when tree farmers get together one of the things we discuss is estate taxes. Estate taxes matter not just to lawyers, doctors and businessmen but to people like Rosett and me.

We were both born on this land that is now a part of our tree farm. I can remember plowing behind a mule for my uncle who owned it before me. My dream then was to own land one day. I bought a small bit in 1940 and inherited some from my family estate in 1946 and then bought some more. Back when I started, the estate tax applied to only 1 estate in 60. Today it applies to 1 in 20, including mine.

Mr. Chairman, you have heard many witnesses talk about the details of estate tax reform. They know more about it than I do, but I know what estate tax reform would mean in places like Montrose, Miss., and to the tree farms like Rosett and I own.

We first got started in forestry in 1960. Much of our land was old cotton and row crop fields, so early on I spent 90 percent of my time trying to keep it from washing away. We have developed a management plan and started growing trees. Today, we manage our property for timber, wildlife habitat, water quality and recreation. We have built ponds for erosion control and for wildlife. Deer and turkey have come.

It took us half a century, but Rosett and I have managed to turn our land into a working tree farm that has been a source of pride and income for my entire family. Our tree farm made it possible to put our five children through college. It made it possible for Rosett and me to share our love of the outdoors and our commitment to good forestry with our neighbors. We want to leave the land in better condition than when we found it here and first started working with it. And we will.

We also want to leave the tree farm in our family. Right now, people tell me that my tree farm could be worth more than $0.5 million—more than $1 million. All that value is tied up in land or trees. We are not rich people. My son and I almost do all the work on this land ourselves. So, under current law, my children might have to break up the tree farm or sell off timber to pay the estate taxes.

I hope the committee will consider a proposal, according to the National Family Enterprise Preservation Act, which would totally exempt over 98 percent of all family enterprises, not just tree farms, from the Federal estate tax. A copy is attached to my written testimony.

Giving up the tree farm we worked 50 years to create would hurt me and my family. If the tree farm had to be sold or the timber cut before it is time, what would happen to the erosion control program we put in place or the wildlife habitat? Who would make certain that the land stayed open for our neighbors to visit and enjoy? I know my children would.

I mentioned earlier that most of the 7 million landowners in this country are close to retirement age or, like me, way past it. Without estate tax reform, many of their properties will be broken up into smaller tracts or harvested prematurely. Some may no longer be economical to operate as tree farms and will perhaps be converted to other uses or back into marginal agriculture. Other properties may become too small or generate too little cash flow to support the kind of multiple use management we practice on our property.

Healthy, growing forests with abundant wildlife provides benefits to everybody. Without estate tax reform, it will become harder and harder for people like me to remain excellent stewards of our family-owned forests.

Mr. Chairman, a few months ago Rosett and I were named Mississippi's Outstanding Tree Farmers of the Year. It was a great honor to be selected from among the thousands of excellent tree farmers in Mississippi. I am told one reason we were recognized was because Rosett and I have been speaking out on behalf of good forestry for almost four decades. That is why I made this trip to Washington, to remind the committee that estate tax reform is important to preserve family enterprises like ours. Landowners feel the same way about their own tree farms.

We applaud estate tax reform that will make this possible. And thank you.

[The prepared statement and attachment follow:]

STATEMENT OF MR. CHESTER THIGPEN

MONTROSE, MISSISSIPPI

BEFORE THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

FEBRUARY 1, 1995

My name is Chester Thigpen. My wife Rosett and I are Tree Farmers from Montrose, Mississippi.

Mr. Chairman, I appreciate the opportunity to appear before this Committee. You are debating an issue that is very important to more than 7 million people who own most of the nation's productive timberland. Most of us have been at it for a long time. Professor Larry Doolittle of Mississippi State University published a paper in 1992 that suggested half the Tree Farmers in the Mid-South were 62 years old or over. This pattern holds true in other parts of the country as well. So it should come as no surprise to the Committee that, when Tree Farmers gather, one of the things we discuss is estate taxes.

Estate taxes matter not just to lawyers, doctors and businessmen, but to people like Rosett and me. We were both born on land that is now part of our Tree Farm. I can remember plowing behind a mule for my uncle who owned it before me. My dream then was to own land. I bought a little bit in 1940 and inherited some from my family's estate in 1946, and then bought some more. Back when I started, the estate tax applied to only one estate in 60. Today it applies to one in 20 -- including mine. I wonder if I would be able to achieve my dream if I were starting out today.

Mr. Chairman, you have heard many witnesses talk about the technical details of estate tax reform. They know far more about it than I do. With your permission, I'd like to take a few minutes to talk about what I do know: what estate tax reform will mean in places like Montrose, Mississippi and to Tree Farmers like me and Rosette.

We first got started in forestry in 1960. Much of our land was old cotton and row crop fields, so early on I spent 90 percent of my time trying to keep it from washing away. We developed a management plan and started growing trees. Today, we manage our property for timber, wildlife habitat, water quality and recreation. We have built ponds for erosion control and for wildlife. Deer and turkey have come back, so we invite our neighbors to hunt on our land.

It took us half a century, but Rosett and I have managed to turn our land into a working Tree Farm that has been a source of pride and income for my entire family.

Our Tree Farm made it possible to put our five children through college. It made it possible for Rosette and me to share our love of the outdoors and our commitment to good forestry with our neighbors. And finally, it made it possible for us to leave a legacy that makes me very proud: beautiful forests and ponds that can live on for many, many years after my wife and I pass on. We wanted to leave the land in better condition than when we first started working it. And we will.

We also want to leave the Tree Farm in our family. But no matter how hard I work, that depends on you.

Right now, people tell me my Tree Farm could be worth more than a million dollars. All that value is tied up in land or trees. We're not rich people. My son and I do almost all the work on our land ourselves. So, under current law, my children might have to break up the Tree Farm or sell off timber to pay the estate taxes. I am here today to endorse a proposal called the National Family Enterprise Preservation Act which would totally exempt over 98 percent of all family enterprises, not just Tree Farms, from the Federal estate tax. A copy is attached to my written testimony.

Giving up the Tree Farm we worked fifty years to create would hurt me and my family. I don't think it would be good for the public either. If the Tree Farm had to be sold or the timber cut before its time, what would happen to the erosion control programs we put in place, or the wildlife habitat? Who would make certain that the lands stayed open for our neighbors to visit and enjoy? I know my children would. And I hope their children will have an opportunity after them.

I think too often people focus on just the costs of estate tax reform and not the benefits. In forestry, the benefits will be substantial. I mentioned earlier that most of the 7 million landowners in this country are close to retirement age or, like me, way past it. Without estate tax reform, many of their properties will be broken up into smaller tracts or harvested prematurely. Some may no longer be economical to operate as Tree Farms and will perhaps be converted to other uses or back into marginal agriculture. Other properties may become too small or generate too little cash flow to support the kind of multiple use management we practice on our property. Healthy, growing forests with abundant wildlife provide benefits to everybody. Without estate tax reform, it will become harder and harder for people like me to remain excellent stewards of our family-owned forests.

Mr. Chairman, a few months ago, Rosett and I were named Mississippi's Outstanding Tree Farmers of the Year. It was a great honor to be selected from among the thousands of excellent Tree Farmers in Mississippi. I'm told one reason we were recognized was because Rosett and I have been speaking out on behalf of good forestry for almost four decades.

That's why I made this trip to Washington: to remind the Committee that estate tax reform is important to preserve family enterprises like ours. It is also important for good forestry. We just planted some trees on our property a few months ago. I hope my grandchildren and great-grandchildren will be able to watch those trees grow on the Thigpen Tree Farm -- and I know millions of forest landowners feel the same way about their own Tree Farms. We applaud estate tax reforms that will make this possible.

Thank you.

THE NATIONAL FAMILY ENTERPRISE PRESERVATION ACT OF 1995

Something has to be done about laws that force inheritors of a family farm or business to sell that enterprise in order to pay estate taxes on it. A family farm or business is not only an extremely productive component of our economy, it also provides a quality of life which millions of Americans cherish.

Forty or fifty years ago productive agricultural land could be purchased for less than $100 per acre. Today, the national average price per acre is over $750. Inflation has made estate taxes a major burden on family farms and businesses. Independent companies are being forced to merge into large corporations because marketable stock can be acquired tax free and many estate tax problems associated with a family farm or business can be avoided.

In 1942, the estate tax applied to only one estate out of 60. Today, this number has increased to one out of 20, significantly broadening the application of the law. The sad fact is that inflation has pushed family farms and businesses that were too small to pay estate taxes into extremely high tax brackets. The result has been that heirs of these enterprises have been forced out of business because they must pay stiff Federal estate taxes.

Inflation and the increase of economic concentration through conglomerate mergers has seriously imperiled the maintenance of family farms and businesses of all kinds. Our existing tax structure has the effect of subsidizing the growth of big business usually at the expense of small and independent enterprise. What we are witnessing today is a major threat to the very survival of our free and independent enterprise system.

Family owned farms and businesses are an integral and vital component of our economy and society. As a source of entrepreneurial spirit, family owned farms and small businesses must be preserved and protected. These enterprises give the family a personal sense of freedom, accomplishment, and pride in ownership. The perpetuation of the family business in America is of significant importance to the survival of free enterprise that is the foundation of our economy.

We therefore propose to introduce the National Family Enterprise Preservation Act of 1995 (the "NFEP"). This measure will provide estate tax relief to more than 95 percent of our Nation's family owned farms and businesses, allowing them to continue their many contributions to the economy, creating more jobs, advancing technology and innovation, and increasing our productivity. The proposal also recognizes the importance of children and other heirs who work in a family enterprise.

THE NFEP

1. **Increase In the Unified Estate and Gift Tax Credit**

The current unified credit of $192,800 would be increased to $314,600 in the case of family enterprise property. This would be an increase from $600,000 to $1 million in the amount of property that may pass free of Federal estate and gift taxes.

2. **Increase In the Annual Gift Tax Exclusion**

The current annual gift tax exclusion of $10,000 would be increased to $20,000 in the case of gifts to qualified family members of family enterprise property. Qualified family members are individuals who are members of the same family within the meaning of section 2032A (e)(2) of the Internal Revenue Code.

3. **Special Use Valuation Changes**

Currently, special use valuation cannot reduce the gross estate by more than $750,000. This amount would be increased to $1 million.

4. **Family Enterprise Interest**

The value of the gross estate shall be reduced by 5% for each taxable year in which a qualified family member participates in the active management of the family farm or business following the decedent's death. The estate will be credited with the maximum deduction at the time of the decedent's death. The qualified family member must continue in the active management of the family farm or business for 10 years following the decedent's death, otherwise appropriate recapture provisions would apply. The term active management means the making of the management decisions of a business other than the daily operating decisions. In no event shall the value of the decedent's gross estate be reduced by more than the lesser of 50% or $1 million by reason of family enterprise interests.

Mr. ENSIGN. Thank you, Mr. Thigpen.
Mr. True.

STATEMENT OF DIEMER TRUE, PARTNER AND SHAREHOLDER, TRUE OIL AND AFFILIATED COS., CASPER, WYO., ON BEHALF OF THE U.S. BUSINESS AND INDUSTRIAL COUNCIL

Mr. TRUE. Thank you, Mr. Chairman. What a privilege it is to be here today on behalf of the U.S. Business and Industrial Council and our company, the True Enterprises.

I am Diemer True. I am from Casper, Wyo. I am in business with my two brothers. We operate an oil and gas business principally, but we also operate a regional pipeline company, a regional trucking company and have a cow-calf operation and two small feedlots.

The essential part of the description of my family's businesses is they are all asset-based operations and the businesses were started in 1948 by our father, H.A. "Dave" True, and basically down through the years we have reinvested every dollar of income back into the businesses.

I am sort of an example of what can go right with estate planning and family businesses and also what is wrong with the current situation. Dad passed away in June 1994, and because of planning that he and mother started over 40 years ago, because of some buy-sell agreements that have been grandfathered in the law, my two brothers and I were able to buy the businesses in accordance with those buy-sell agreements.

This is not an academic endeavor from my standpoint, granted that half of the work force in America today is employed by small family businesses and two-thirds of all of the new jobs come from small family businesses. But the problem that I represent is we don't know where to go with the third generation.

The three problems with the current estate tax law as we see it is the extremely high and the steeply graduated tax where, in an asset-based family business, there is not the liquidity to pay that tax, as other witnesses have identified.

The other thing, the other problem is the cumulative effect. In other words, every 20 to 30 years, as another generation is faced with paying 55 percent of the family business to the Federal Government, then the business has to retract 55 percent, and we have another 20 years or another generation of trying to rebuild the business.

Finally, the fatal flaw in the estate tax in my opinion is its complexity. I listened with interest to two earlier witnesses, one an attorney and one a CPA, and they said it was complicated but don't let the complication bother you. As a businessowner, let me tell you, it is a fatal flaw, because we cannot plan. We simply cannot say to our 773 employees what the business will look like 20 years from now when my brothers and I retire.

The options that I am suggesting are options. They ought not to be considered in a package, but ought to be looked at individually, and I would hope that the committee would be aggressive and bold as they look at the estate tax.

First of all, I think any option that you look at ought to be considered in the light of simplification. Let us know what the rules are and then we can play the game.

Second, I would hope the committee, and I think this arguably is revenue-neutral, ought to consider reauthorizing in the statutes intergenerational buy-sell agreements, such as the ones that my brothers and I are the beneficiaries of, if you will, in being able to buy mother and dad out of the business.

In 1984 my sister withdrew from the business, and at that time, rather than it being an acrimonious circumstance, we knew ahead of time not only what we were going to pay her for her share of the business, but she knew what she would receive for her share of the business.

I really do applaud the increase in the unified credit that is embodied in the Contract With America. That is a great step forward, and I hope that will be considered and adopted.

There are a number of other countries which have low estate taxes—Ireland, for example, has only a 2 percent estate tax; Australia, none. Sir John Templeton, you know, has actually renounced his citizenship and moved to the Bahamas because of the estate tax.

I think we ought to seriously consider reducing in its entirety the estate tax to zero or to a very low flat rate.

Mr. Chairman, I am most grateful for the opportunity to be here and to present these options.

[The prepared statement follows:]

Testimony of
Diemer True
Partner and Shareholder
True Oil and Affiliated Companies
on Behalf of the United States Business and Industrial Council

on
Estate Tax Reform and Small Business

Mr. Chairman and members of the Committee, I am Diemer True, a partner and shareholder in True Oil Company and its affiliated companies in Casper, Wyoming. The True Companies is a group of family-owned businesses, most of them partnerships of S corporations, headquartered in Casper.

The companies were started by my father, H. A. "Dave" True, Jr., in 1948. The True Companies have principally been involved in oil and gas exploration and development and have expanded its operation regional pipelines, a regional trucking company, a local bank, and an agricultural business, including a cow-calf operation, two small feedlots, and a farm. The companies now employ 773 hard working Americans in the Rocky Mountain states.

In June, 1994, my father passed away. My two brothers and I purchased the bulk of the businesses from his trust and our mother. The purchase was made possible by the planning done by my parents, beginning forty years ago, principally using but-sell agreements. We, three brothers, manage the businesses.

I am here on behalf of the True Companies and the United States Business and Industrial Council. We appreciate this opportunity to offer our comments on various aspects of the federal estate tax, including proposals for change, from the perspective of a second-generation owner of a family business.

Introduction

The federal estate tax laws are a disaster for closely-held businesses. We believe the estate tax is the single greatest impediment to keeping family businesses functioning as such from one generation to another. The sad truth is that in the United States, the founder of a family business spends thirty or forty years building the business, but faces almost insurmountable barriers to passing it on to his or her children. Most founders must choose between selling the business to outsiders or leaving a life's work to almost certain dismemberment at the hands of the estate tax.

Today's world markets demand that American businesses be creative, productive and flexible. It is too much to ask that closely-held American businesses at the same time fight destruction by a confiscatory estate tax.

The small business firm, whether defined in terms of capitalization or number of employees, is the bedrock of the American free-enterprise economy. Small businesses – which are family-owned for the most part – comprise 99 percent of the private sector, with the large "Fortune 500" companies comprising the remaining 1 percent. Most of the "Fortune 500" companies are multi-national economic empires that also operate in many foreign countries. Much of their activity is outside the American economy. In terms of employees, about one-half of all American workers are employed by small businesses. Small business has been creating about two-thirds of all new American jobs. My comments are not intended to be critical of the

"Fortune 500" companies, only to demonstrate that domestic economic vitality and job creation comes largely from the small business entrepreneurial spirit and that the current estate tax law is counterproductive to small closely-held businesses.

A tax that disproportionately and severely affects family businesses is therefore a threat to American competitiveness and job growth. The existing estate tax structure needlessly penalizes the most important part of the private sector -- small business. I am here because the True Companies and the United States Business and Industrial Council hope the new Congress will be looking for ways to sustain the economic viability of this sector of the American economy, and that Congress should specifically look at changing the Federal estate tax.

The Problem of Complexity

One of the principal problems with the estate tax is its complexity. Like the federal income tax, the estate tax has become increasingly complex since the present scheme was adopted in 1932. This increasing complexity has touched every aspect of the tax, but perhaps none so extensively as what property is to be included in that estate for tax purposes and how that property is valued.

Property owned at death is obviously subject to the estate tax. Property need not be owned solely or outright to be included in some way in the gross estate. A large body of law, both statutory and case law, has emerged on the composition of the "gross estate." The gross estate may include, among other items:

- property transferred within three years of death;
- property transferred with retained rights of enjoyment;
- transfers that are in some way revocable;
- property over which the decedent has a general power of appointment;
- jointly-owned property; and
- life insurance policies with respect to which the decedents retain some incidents of ownership.

Valuation of the property in the gross estate is as critical to a determination of liability as a determination of what property is includable in the gross estate. Although property is generally valued at fair market value as of the date of death, the precise method of valuation is generally left to statutes, the judicial decision and administrative regulations and rulings. The lack of statutory rules and the infinite variety of property frequently make valuation the most difficult aspect of determining the estate tax.

Valuation is almost always at issue for interests in closely-held businesses, and under current law constitutes one of the greatest problems under the estate tax. Publicaly-held comparable businesses are usually very difficult, often impossible, to find. Valuing the stock or a partnership interest almost always becomes a matter for extremely expensive litigation requiring the testimony of highly-paid valuation experts -- "hired guns." The Internal Revenue Service has typically taken an aggressive position on these valuation issues, as its $600 million loss in the Estate of Newhouse case demonstrates.

The lack of a market for interests in closely-held businesses is sometimes anticipated by the use of a buy-sell agreement. Buy-sell provisions mandate the sale, or offer of sale, of a business interest to another owner of the business at a stated price or at a price determined according to a specified method. In the past, such agreements typically attempted to both create a market for interests in the business and, perhaps more importantly, provide a method for valuing the business interest for estate purposes using some easily applied formula, such as book value.

A body of law emerged from the courts and the Internal Revenue Service as to when a buy-sell agreement would be respected for purposes of valuation. A buy-sell agreement typically established valuation if the agreement applied to both lifetime and time of death transfers; mandated the sale of the business interest by the estate of a deceased business owner; was supported by bone fide business purposes; and prescribed an ascertainable sale price or methodology for determining price.

My father saw the need for book value buy-sell agreements forty years ago. Such provisions were included in the family's first partnership agreements. When my sister withdrew from the family businesses in 1984, they provided a certain means of computing the sale price of her business interests, which the remaining family members purchased. When my father passed away last year, the buy-sell agreements again provided a method by which his interests could be valued in the sales to other family members. We hope the long history of using book value buy-sell agreements in my family's businesses will help us avoid a challenge to their validity from the Internal Revenue Service.

Most other family businesses do not have this option. The case law allowing book value buy-sell agreements was essentially repealed with the adoption in 1987 of the so-called estate freeze valuation rules in the Internal Revenue Code Section 2036(c). My family's agreements were grandfathered and therefore remain valid. Although Section 2036(c) generated a storm of controversy and was retroactively repealed by the Omnibus Reconciliation Act of 1990, a new chapter was added to the Code covering various valuation issues. The new provisions, although much more detailed and less ambiguous than Section 2036(c), have added an entire new set of complexities to the existing valuation problem. The effect of the new provisions on closely-held businesses is essentially to abandon such businesses to expert witnesses and trial lawyers to litigate the issues of fair market value in the tax courts. The high cost of litigation is an additional financial burden which compounds the difficulty of keeping small businesses intact.

As you may be aware, the Internal Revenue Code also provided for an optional method of valuing limited amount of so-called "qualified property" – generally real property used before and after death for farming purposes or in a closely-held business. Qualified property may be valued according to its actual use, not its highest and best use. While not disparaging the usefulness of this optional valuation method to certain taxpayers, the statute is highly technical and limited in scope. The case law is replete with situations of taxpayers who ran afoul of ambiguities and technicalities in the statute and who paid dearly.

As the experience with this special valuation method demonstrates, the complexities of the estate tax for closely-held businesses are not solved by adding new provisions to the Internal Revenue Code.

The Estate Tax's Confiscatory Rates

In addition to the tax's complexity, closely-held business suffers at the hands of the estate tax's rates. Those rates are both confiscatory and steeply graduated.

The rates begin at 18 percent but reach 41 percent at $1 million; 49 percent at $2 million; and the maximum rate of 55 percent at $3 million. Borrowing a concept employed by the income tax, a 5 percent surtax is imposed that effectively phases out the graduated rates and the unified credit on larger estates.

Because the rates hit confiscatory levels at such a low threshold, the estates of many closely-held business interest owners are subject to the maximum rate.

The Unified Credit

Those not familiar with family businesses might believe that the unified credit avoids these complexities, including valuation problems, as well as the confiscatory rates, for a significant number of business owners. The so-called "unified credit" is a credit equivalent to the tax on a taxable estate of $600,000 for decedents dying after 1986. The unified credit is applied first to lifetime taxable gifts, thus first eliminating any gift tax, with any remaining credit available for transfers at death. The credit has not been adjusted since 1986.

One reason the federal estate tax is such a disaster for closely-held agricultural operations and businesses is that the unified credit amount protects only the smallest of such businesses. Most are exposed to the full effects of the tax. Increasing the credit from $600,000 to $750,000 and indexing it, as proposed in the "Job Creation and Wage Enhancement Act" (H.R. 9), will restore the credit to prior levels in real terms and is a needed first step.

The Effects of the Estate Tax on Closely-Held Businesses

The effects of the tax on the owner of closely-held business are profound. Our family has had to address those effects in order to keep our businesses functioning. From my family's perspective, let me describe how the tax has affected us.

The federal estate tax is hurting family-owned business in two ways. First, its steeply graduated and high marginal rates generate a large tax liability relative to the value of the business. Our businesses, like most family businesses, were built by reinvesting profits. We could not have done it while carrying a debt load. The vast majority of sole proprietorships or other family businesses are therefore not liquid enough to pay a significant amount of tax. Such businesses also many have difficult borrowing the funds. Although life insurance is sometimes available to fund the estate tax liability, the premiums themselves are a significant diversion of necessary cash. Furthermore, as a matter of tax policy, we do not believe that a family business should have to divert cash into passive investments and away from job-creating assets in anticipation of the estate tax.

I am aware that the Internal Revenue Code allows a deferral of payment of the portion of the estate tax attributable to the value of active business assets in a closely-held business, if the value exceeds 35 percent of the value of the estate. If an estate qualifies under this limited provision, the tax may be deferred for five years, after which it may be paid in ten annual installments. This deferral, however, may not save the business, but result only in its slow strangulation.

Thus the founder of a business who wishes that business to survive his death (and what founder doesn't), may be forced to decide between two options. One is selling all or part of the business to an outsider, instead of bringing in his own family. The other is passing the business to his own family members, gambling that the business will survive the crushing debt of the estate tax. Without our grandfathered book value buy-sell agreements, my father would have had to make this choice.

The second damaging effect of the estate tax on our businesses will be its cumulative effect. The estate, gift and generation-skipping tax systems are integrated to ensure that, as much as possible, the transfer of property is taxed in every generation – typically every twenty years or so. Absent a sale to a group of outsiders, the practical result of the estate tax's cumulative effect – viewed most optimistically – will be an ongoing cycle of business contractions between attempts to restore the businesses to their previous vigor. How is a business to compete in the world economy and offer stable jobs under those conditions?

Let me comment here about a proposal that surfaces occasionally that affects the federal income tax. The current estate tax allows a step-up in tax basis for assets included in an estate. That means that the tax basis is automatically increased from the decedent's tax basis to the date-of-death value. On occasion it has been proposed that the step-up rule be repealed and that a decedent's basis be carried over to his survivors. This change could add a significant income tax burden to the estate tax burden, overwhelming businesses already under siege.

What Congress Should Consider

The Federal estate tax is overwhelming in its complexity, is confiscatory, and in the long term, is counterproductive to economic growth and job creation. If family businesses are to survive as such and continue to generate more jobs and economic growth, Congress needs to take action now to stop the tax's effects on closely-held businesses. Among the options:

- Simplify the estate tax. As Congress examines various proposals for change, simplifications should be among your goals.

- Repeal restrictions on the use of buy-sell agreements and similar devices that attempt to make more certain the value of a closely-held business for both business and estate tax purposes. Establishing a market and a methodology for valuing business interests is critical for both lifetime and at-death transfers of closely-held business interests. Previous law on the validity of buy-sell agreements should be restored, both for business reasons and for relief from the estate tax. This option is not included in H.R. 9 or the proposal of the National Federation of Independent Business (NFIB).

- Eliminate the estate tax on certain business assets, including ownership interests in closely-held farms and business, in which the decedents actively participate. If ownership interests in one or more qualified family-owned business constitute 50% or more of the value of the gross estate and are conveyed to qualified heirs, then these interests should be excluded from the decedent's estate. A qualified family-owned business should include the broadest range of business entities possible, regardless of legal structure. The proposal of the NFIB includes a change along these lines.

- Significantly increase and index the amount of the unified credit so that it effectively protects an interest in the small or medium-sized family business. Indexing the credit or restoring it to its prior real level, while helpful, are insufficient to provide significant relief. An even greater increase would be more appropriate.

  The Job Creation and Wage Enhancement Act (H.R. 9) would raise the estate tax exemption from $600,000 to $750,000, and index the exemption to inflation. The U.S. Business and Industrial Council strongly supports this proposal. This is a very needed first step, but the USBIC proposes further that the value of family or closely-held business, farm and ranch assets in an estate be exempted altogether from estate taxes.

- Reduce the rates on qualified family-owned businesses that continue to be owned and actively managed by a family member. An alternative to an exemption is a special reduced estate tax rate for family business interests and business assets held by sole proprietors. A recapture provision could require that business interests be held for a period after the death of the decedent, and that the heirs materially participate for that period, in order for business interests to continue to qualify. This option is not included in H.R. 9 or the proposal of the NFIB.

- Apply a flat estate tax rate to interests in closely-held businesses. Instead of the steeply-graduated and confiscatory rates under the current tax, a single low rate could apply to business interests and business assets. This option is not included in H.R. 9 or the proposal of the NFIB.

- Expand the applicability of the deferred payment provisions, including the four percent interest on deferred taxes. These provisions are extremely limited under current law, both in terms of qualifying and the portion of tax to which they apply. The deferred payment provisions should be made more helpful to family businesses and the four percent interest provision should be applicable to all the tax attributable to qualifying business interests. The proposal of the NFIB includes such a proposal.

Conclusion

The federal estate tax is a matter of extreme importance to family businesses in this country. In markets that are now world-wide, the pressures on businesses of competition and providing stable jobs are enormous. The added pressures on family businesses of surviving the federal estate tax are too much more to bear. With small family businesses being such a significant sector of the American economy and providing so many of the new jobs being created, this is a critical issue for the new Congress. If businesses like my family's are to continue in the hands of my children and grandchildren, my nieces and nephews, and in our community, small businesses need relief from this tax.

On behalf of the U.S. Busiiness and Industrial Council, my family and companies, I wish to thank the Committee for the opportunity to present these comments.

Mr. ENSIGN [presiding]. I want to thank the entire panel for their testimony.

Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman.

I want to thank each of our members of our panel. I have a question for you, Mr. Turner.

My background is one of coming from a rural area. I am from a ranching background myself, small business background; I can relate to what you are saying.

Mr. True, it is interesting that one of the stated purposes ironically of this estate tax from those who support it is to break up, purposely—to do just what we are hearing that they are trying to do with your family, Mr. True—is to break up family holdings, even though only 1 percent of the total Federal revenues come from this tax.

I would like to ask a question of you, Mr. Turner. If you could tell me, from your experience, when the Federal estate taxes force a cattle rancher to sell either part or all of his ranch, does the sale really break up the assets, and are those assets then passed down to the "little fellow" to give them a chance? What is your experience in this?

Mr. TURNER. My experience is not just in agriculture, Congressman, but in family-owned businesses generally, that there isn't enough capital out there among other little guys to go purchase these assets from estates to generate the kind of splitups that was perhaps intended when the estate tax was implemented. The only ones with the capital sufficient to do that are large publicly owned corporations or the like, that step in, buy the assets from the families in these estates, generating more concentration rather than less concentration. The census statistics from the Department of Agriculture bear this out.

We feel that estate taxes are one of perhaps several reasons that are causing the number of operations in this country, at least in the cattle business, to substantially decline. The graph is dramatic from 1965. It has just fallen off the table. And we think the estate taxes have been counterproductive indeed, to whatever goal may have initially been there to split up operations, to diffuse concentrations of wealth.

[At the time of printing, the graph had not been received.]

Mr. HERGER. Well, then just a followup question. What are the options then that the rancher would have once the Federal Government "becomes a co-owner of his upon the death of a family member"?

Mr. TURNER. Unfortunately, Congressman, I think the options are limited. You, of course, have the sale options, which is bad for the country, bad for local economies, bad for rural America. You have the debt option. Go to your Federal land bank, go to the section 6166 provision of the code, allow Uncle Sam to be your banker, pay the estate tax off in installments.

But whether you borrow the money to pay estate taxes commercially or avail yourself of section 6166, the estate tax rates are so high that the debt service burden on family ranchers and successive generations is so bad that there is just a slow strangulation of the business. If they can afford to carry the debt for a couple of years, well, maybe they can do that. But eventually, it just chokes off the incentive of that next generation to continue in the enterprise.

Mr. HERGER. Thank you.

Again, my experience being in an agricultural area, it is not unusual at all to have families that have been working a ranch or a farm for three, four, maybe even five generations, and it becomes progressively more difficult, as you pointed out, Mr. True, to be able to keep that family, and really, we are talking about someone again who grew up on a ranch, really a way of life. The amount of profit is such a small one; you are working on very small, limited returns to begin with, and it just makes it that much more difficult.

Mr. Thigpen, I thank you for your comments. We have so many different examples, not just in ranching, but so many small family enterprises out there that are trying to make the American dream work for themselves and for their children, it is really a tragedy what we see happening. Again, I thank you for your comments and your testimony.

Thank you, Mr. Chairman.

Mr. CRANE [presiding]. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman, and I appreciate the testimony of all of the witnesses. It seems that, if I understand your testimony correctly, although the increase of the exemption level from $600,000 to $750,000 will have a positive impact, there is a lot more that we need to do in order to be able to preserve family businesses. I see from the nods that there is general agreement from the panel.

I am intrigued about the buyout contracts and why you were able to do it in your circumstance, but no longer would we be able to have those types of arrangements. My family has a family business. We are now in the third or fourth generation and we had severe problems to get to that point. In fact, most families are no longer in the business, but it was not an easy way to work it out, and the tax laws played a part, among other considerations.

So I am curious as to what we can do as far as the potential for buyout arrangements among families that you would recommend as a way of improving the chances of family businesses being able to survive beyond maybe one or two generations?

Mr. TRUE. May I respond to that, Congressman?

The current problem was created with the adoption of section 2036(c) of the code in 1987 which dealt with the estate tax freeze provisions. With the repeal of that in 1990 and the adoption of chapter 14, we grandfathered in the existing buy-sell agreements, but we still had some problems intergenerationally.

Now, you can still enter into buy-sell agreements outside family members, but you can't enter into intergenerational buy-sell agreements. The buy-sell agreements are particularly attractive because it allows you to plan. You have to establish a business purpose; you have to establish a reasonable value, and then it creates particularly a market, you see, for a closely held business. We own all of the stock in our business, the family does.

So when my sister withdrew in 1984, there was no other market. But she knew ahead of time what the price was and we knew what the price would be in order to buy her out.

Mr. CARDIN. My general recollection is that in 1990 that action was taken because we were freezing the value at current value with an appraisal, but then issuing additional equity in the corporation and trying to avoid taxes. Was it——

Mr. TRUE. That was a corollary situation where you would have an equity stock issued to the successive generations and preferred stock retained by the senior generation. That is not the circumstance in our case.

Mr. CARDIN. But I think that the action taken by Congress was to prevent that type of tax avoidance.

Mr. TRUE. That is true, and I am not sure that is a justified public policy reason. In that particular case, they were trying to continue to break up family businesses, which I don't think is the appropriate public policy purpose. In our particular case, we are based in Casper, Wyo.

If we had to liquidate our business as an asset-based business, those assets would probably go to Denver and Houston, frankly.

Mr. CARDIN. I think your point is well taken, and if any other panelist wants to respond, please do. The reaction in 1990 was understandable because of the expansions of these types of avoidance schemes or advice that was being given by just about any tax planner, but we didn't replace it with anything, we didn't take care of the legitimate problems that you are referring to.

Mr. TRUE. That is correct.

Mr. CARDIN. So we really need to take a look at this again. I am not so sure that reinstating the prior rules is reasonable, but we need to take a look at what could replace it.

I guess my concern is that if we pass the provisions that are in this contract, we still have a major problem ahead of us that we have to take a look at if we are going to be able to preserve small family businesses in our community. Anyone else wish to comment? Fine. I have 30 seconds left on my time.

If not, let me again thank you all for your testimony.

Mr. CRANE. Let's see.

Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

And thank you, gentlemen. I think your testimony has been outstanding, a poignant presentation of some areas where we obviously need to do a lot of work here at the Federal level.

Mr. True, I want to say hello to you. I greeted members of your family on November 3 in Casper, Wyo. It was the day of the snowstorm and I enjoyed getting to know your airport very well.

Mr. TRUE. We were glad you were there.

Ms. DUNN. Thank you. It was delightful. A very successful venture, I am so pleased to say.

Mr. McNutt, Mr. Thigpen, Mr. Lange, all of you did a terrific job of bringing something to our attention, that it is vitally important as we talk about this estate tax relief that we have to push forward and that is the nonliquidity of certain types of products.

As I mentioned earlier when Mr. Barrett was testifying, I represent a very large district in Washington State, some of which is around Mt. Ranier, and that we have many small timber farms that exist there, and the fact that that is a long turnover sort of product makes the situation almost impossible. So that young families who are taking over after the death of a parent really have great trouble financing the estate tax and often simply have to cut the timber off that property to pay the estate taxes and often sell the property. And, as Mr. Turner said, it becomes houses and it is a great loss, I believe. Certainly I have seen that happen in my own district.

I suspect that in order to compensate for this big problem that we are all facing, you find yourself looking for legal tax loopholes. And I would be curious if you could fill me in on, if there has been some action you have taken to help you solve this problem.

And I welcome any response. Mr. True, perhaps you have some thoughts.

Mr. TRUE. Well, thank you, Congresswoman, and it is good to see you again. Thank you.

We are currently in the process of engaging some very expensive lawyers, accountants and life insurance people. And I have dragged my feet in that exercise, as my father did before me, because it seems to me as a matter of public policy it doesn't make any sense to divert the necessary capital that we reinvest into our business and divert it into large life insurance policies which, yes, indeed at some future date would provide the liquidity necessary for us to pay those estate taxes, but what it does right now is it constrains the economic opportunities that our business would have. So we have been resisting that. But I know that at some future date we will have to pay the piper if we don't plan now.

Ms. DUNN. And that sort of thing of course cuts back on your capital that you have to invest in the company.

Mr. TRUE. Exactly. It is counterproductive.

Mr. MCNUTT. I think a real tragedy in this whole scenario and regrettably it extends throughout the whole tax system of taxation is that it is so complex that it forces the taxpayer to literally play games to try to find where you can penetrate the wall, where can you save a dollar.

You know, it is easy to understand why people without any real knowledge of it love this flat tax idea. You do a little postcard, it is marvelous, it is marvelous. But to have to go out and spend so much money for tax planning, accountants, attorneys, to look for ways to conserve your own money and shield it from the Federal Government is just a basic flaw I think in our tax policy.

Mr. CRANE. Ms. Dunn, are you finished?

Ms. DUNN. Unless any of the other gentlemen have a response.

Mr. LANGE. A quick response. One thing that is semirelated. The capital gains tax of 28 percent, if we had a farm today, we could sell our farm and pay 28 percent capital gains. If we hold on to the farm and the owner dies, then we are assessed up to 55 percent. So there is no—it is hard to have incentive to hang on to the farm when you know that you are going to get hammered twice as hard by holding on to it.

Mr. TURNER. Let me just respond quickly if I might to the complexity issue since I practice somewhat in this area. Looking at 2032(a) itself, and we appreciate Congressman Herger's and others' efforts to broaden the relief under that, but to take the maximum benefit of it, you need to take advantage of those limits in that code section in both estates.

So typically you have a spouse that dies, because the unlimited marital deduction gives everything to the surviving spouse, then that surviving spouse has to execute a disclaimer to create some tax in the surviving spouse's estate to take advantage of section 2032(a), so that then when the surviving spouse also passes away, he or she can then take advantage of the benefits and limits of section 2032(a) again in their estate, and so forth and so on, and so it goes. Very complex. And to have so much complexity, to plan around a tax that is such bad, counterproductive public policy anyway we think is just nonsensical.

So certainly our organization not only advocates some amendments to current law, but really urges a look at the entire public policy behind the estate tax.

Ms. DUNN. Thank you.

Mr. CRANE. Mr. Payne has a quick question, but first let me counsel the members of the panel. We appreciate your appearance here. Because we have a vote, after Mr. Payne's questions, what I would like to do is recess the committee and let you folks be excused, and thank you again.

Proceed.

Mr. PAYNE. Thank you very much, Mr. Chairman. I will be very brief.

I want to thank all of the panelists for the testimony. I think it has been very helpful. Since I have a very brief amount of time, I will address my comments to Mr. Lange with whom I was working on a piece of legislation in the last Congress. As he mentioned, Mr. Schultz on this committee offered a similar bill two Congresses ago, and shortly Mr. Houghton and I will introduce the American Farm Protection Act of 1995. This essentially will contain a provision that will allow rural landowners within 50 miles of a defined metropolitan area, who voluntarily and permanently provide for the commitment of their land to rural land use through a donation of a qualified conservation easement, to exempt this from the Federal estate tax.

I have a lot of statistics about what is going on in my district alone. We have lost 5,000 farms in the last 20 years. On this panel as we look at all of the members, more than 25,000 farms have been lost in the last 20 years. And this is clearly a situation which we should address and the Contract With America is the right place to address it.

So I encourage the committee to look at the American Farm Protection Act as a part of the Contract With America.

I thank the panelists again, and, Mr. Chairman, I yield back the balance of my time. Thank you.

Mr. CRANE. Again, we thank you. The committee is recessed until 2 p.m.

[Recess.]

Mr. MCCRERY [presiding]. The committee will come to order.

Our next panel can take their seats at the witness table and we will resume testimony. We have with us a Member of the U.S. Senate, former Member of the lower House, Hon. Robert Smith, and we have with us a most respected member of the majority in the House of Representatives, Robert Walker from Pennsylvania.

Gentlemen, welcome to our committee and we will be pleased to take your testimony. Anything that you have prepared in writing, we will submit for the record, and if you would summarize your testimony orally and if you can stay for questions, we will start with Senator Smith, or if you all had decided on another order.

Mr. WALKER. I will go ahead and start.

Thank you, Mr. Chairman.

Mr. MCCRERY. Mr. Walker.

STATEMENT OF HON. ROBERT S. WALKER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. WALKER. Mr. Chairman, one piece of H.R. 9 title XI is the Taxpayer Debt Buydown Act, and we believe this to be an effective and innovative plan to cut the runaway Federal budget deficit and reduce the $4.6 trillion national debt. It is a revolutionary attempt to bring the American taxpayer directly into the budget process, a plan that will give the taxpayers the power they need to participate in controlling Federal spending.

This legislation would allow each taxpayer to contribute up to 10 percent of his or her tax liability to a public debt reduction fund. The corresponding reduction in funds to the government could result in an across-the-board sequester of all accounts, except Social Security retirement benefits, interest on the debt, deposit insurance, and a few other minor contractual obligations of the Federal Government.

Both OMB and CBO have had an opportunity to examine this measure. It works and would balance the budget in 6 years and zero out the debt by the year 2008 under full participation. If public debt is not reduced in the same time period, it will increase to over $12 trillion. CBO is currently restoring this bill for inclusion in the Job Creation and Wage Enhancement Act.

Changes have been made to accommodate some concerns that have arisen about the bill. The legislation would have locked back all public debt including the public trust fund. I am extending the retirement trust fund to the new version of the bill, which are one of the three of the largest trust funds, so that they would not end up being defunded. They are the Social Security Trust Fund, the Civil Service and the military retirement trust funds.

Due to the imminent passage of the balanced budget amendment, discussions are under way about the simultaneous implementation of the balanced budget amendment and this buydown plan. In new language, the checkoff would count only if the amount is greater than the cuts that Congress have already implemented.

For example, if Congress passes a reconciliation bill this year, which designates cuts at $50 billion in 1998, and the checkoff in 1998 totals $60 billion, only an additional $10 billion would be cut under my legislation, rather than under the legislation—rather than cuts. That would total $110 billion, as some people had said the bill would do. If the checkoff is only $40 billion, then nothing would happen. In other words, it would not be necessary to move forward.

Due to the Treasury Department concerns and the concerns of estimating, I am building a 1-year time lag into the measure. For example, if the American people were to take advantage of the 10 percent this April 15, the IRS would have until October 1995 to estimate the amount. This figure would then be submitted to Congress in February 1996 as part of the President's budget for fiscal year 1997. Congress would then have until October 1996 to make the cuts before a sequester would be mandated.

Originally I had only exempted the Social Security retirement account's interest on the debt and deposit insurance. During consultation with the House Budget Committee, the Ways and Means Committee and CBO, it was pointed out that there were several other accounts where there were contractual obligations of the Federal Government and therefore they had to be fully funded. Examples include judges' salaries, payments resulting from government insurance and guarantees. These accounts are negligible financially and will have little effect on the estimates within the measure.

We are attempting to incorporate all of the various changes that people have told us need to be done in the bill, and I think we have done this.

This measure has broad support. I reintroduced it on the first day of the 104th Congress and we now have 84 cosponsors. On the Senate side, Bob Smith, who is here with me today, is lead sponsor. Norm Ture, president of IRET, Paul Merski of CSE, Tom Schatz from CAGW are all here today. Other long-term supporters include Lawrence Kudlow, the economics editor for the National Review and the National Taxpayers Union.

We have had very, very good polling results. Any time that this has been polled, it has shown heavy acceptance amongst the American people, and I believe that debt buydown takes an intractable issue of spending cuts outside the halls of Congress into the households of the American people and would assure that we would have a combination of getting something done about the debt and doing so with almost a national referendum.

I thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF

CONGRESSMAN ROBERT S. WALKER

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

FEBRUARY 1, 1995

THANK YOU VERY MUCH FOR THE OPPORTUNITY TO TESTIFY ON WHAT I BELIEVE IS AN EFFECTIVE, INNOVATIVE PLAN TO CUT THE RUNAWAY FEDERAL BUDGET DEFICIT AND REDUCE THE $4.6 TRILLION NATIONAL DEBT.

THE TAXPAYER DEBT BUY-DOWN ACT IS MORE THAN A DEBT AND DEFICIT REDUCTION PLAN. IT IS A REVOLUTIONARY ATTEMPT TO BRING THE AMERICAN TAXPAYER DIRECTLY INTO THE BUDGET PROCESS; A PLAN THAT WILL GIVE TAXPAYERS THE POWER THEY NEED TO PARTICIPATE IN CONTROLLING FEDERAL SPENDING. IN FACT, IF PASSED, THIS LEGISLATION WOULD BE A REFERENDUM EVERY APRIL 15 ON FEDERAL EXPENDITURES.

THE LEGISLATION WOULD ALLOW EACH TAXPAYER TO CONTRIBUTE UP TO 10% OF HIS OR HER TAX LIABILITY TO A PUBLIC DEBT REDUCTION FUND. THE CORRESPONDING REDUCTION IN FUNDS TO THE GOVERNMENT COULD RESULT IN AN ACROSS-THE-BOARD SEQUESTER OF ALL ACCOUNTS EXCEPT SOCIAL SECURITY RETIREMENT BENEFITS, INTEREST ON THE DEBT, DEPOSIT INSURANCE, AND A FEW OTHER MINOR CONTRACTUAL OBLIGATIONS OF THE FEDERAL GOVERNMENT.

A LOT OF CONTROVERSY AND MISINFORMATION HAS ARISEN ABOUT THIS LAST POINT. DIRE PREDICTIONS HAVE BEEN MADE ABOUT THE COLLAPSE OF GOVERNMENT UNDER THE SEVERITY OF THESE CUTS. THOSE PREDICTIONS ARE NONSENSE! I WOULD LIKE TO POINT OUT THAT, EVEN WITH MAXIMUM TAXPAYER PARTICIPATION, OUTLAYS WOULD CONTINUE TO INCREASE ACCORDING TO THE OMB ESTIMATES. GOVERNMENT SPENDING WOULD CONTINUE TO GROW DURING THE TIME WE ARE COLLAPSING THE DEBT TO ZERO IN 15 YEARS. HOW CAN SOMEONE PREDICT THE COLLAPSE OF THE GOVERNMENT ON FUNDING LEVELS WHICH ARE HIGHER THAN THOSE WE HAVE TODAY? SPENDING PRIORITIES WOULD HAVE TO BE REALLOCATED AND GOVERNMENT NON-ESSENTIALS WOULD HAVE TO BE ELIMINATED, BUT THERE WOULD BE PLENTY OF MONEY TO DO THE NECESSARY WORK OF NATIONAL GOVERNMENT.

BOTH OMB AND CBO HAVE EXAMINED THIS MEASURE. THEY CONCUR THAT THIS IDEA WOULD BALANCE THE BUDGET IN SIX YEARS, AND ZERO OUT THE DEBT BY FISCAL YEAR 2008, UNDER FULL PARTICIPATION. IF THE PUBLIC DEBT IS NOT REDUCED IN THE SAME TIME PERIOD IT WILL INCREASE TO OVER $12 TRILLION!

CBO IS CURRENTLY RESCORING THIS BILL FOR INCLUSION IN THE JOB CREATION AND WAGE ENHANCEMENT ACT.

A FEW CHANGES HAVE BEEN MADE TO ACCOMMODATE CONCERNS THAT HAVE BEEN RAISED. (1)THE LEGISLATION WOULD HAVE BOUGHT-BACK ALL PUBLIC DEBT, INCLUDING ALL THE RETIREMENT TRUST FUNDS. I AM EXEMPTING THE RETIREMENT ACCOUNTS, WHICH ARE THREE OF THE LARGEST TRUST FUNDS, FROM BEING DEFUNDED. THEY ARE: THE SOCIAL SECURITY TRUST FUND, CIVIL SERVICE, AND MILITARY RETIREMENT FUNDS. I AM CONCERNED THAT IF THESE ACCOUNTS ARE DEFUNDED, QUESTIONS MAY ARISE ABOUT THEIR FINANCIAL INTEGRITY, AND THE ENTIRE ACCOUNT COULD BE JEOPARDIZED.

(2)DUE TO THE IMMINENT PASSAGE OF THE BALANCED BUDGET AMENDMENT (BBA), DISCUSSING ARE UNDERWAY ABOUT THE SIMULTANEOUS IMPLEMENTATION OF THE BBA AND THE BUY-DOWN. IN THE NEW LANGUAGE, THE CHECK-OFF WILL COUNT ONLY IF THE AMOUNT IS GREATER THAN THE CUTS THAT CONGRESS HAVE ALREADY IMPLEMENTED. FOR EXAMPLE, IF CONGRESS PASSES A RECONCILIATION BILL THIS YEAR WHICH DESIGNATES CUTS OF $50 BILLION IN 1998 AND THE CHECK-OFF IN 1998 TOTALS $60 BILLION, ONLY AN ADDITIONAL $10

BILLION WILL BE CUT UNDER MY LEGISLATION, RATHER THAN CUTS THAT WOULD TOTAL $110 BILLION. IF THE CHECK-OFF IS ONLY $40 BILLION, THEN NOTHING WILL HAPPEN.

THEREFORE, THE AMERICAN PEOPLE WILL BE TELLING CONGRESS IF THEY ARE ON THE RIGHT BUDGET TRACK, OR IF THEY WANT FURTHER SPENDING REDUCTIONS.

(3)THE TREASURY DEPARTMENT WAS CONCERNED ABOUT THE TIME INVOLVED IN ESTIMATING THE AMOUNT OF THE CHECK-OFF FOR CONGRESS. THEREFORE, I AM BUILDING A ONE-YEAR LAG TIME INTO THE MEASURE. FOR EXAMPLE, IF THE AMERICAN PEOPLE WERE ABLE TO TAKE ADVANTAGE OF THE **10%** THIS APRIL 15TH, THE IRS WOULD HAVE UNTIL OCTOBER, 1995 TO ESTIMATE THE AMOUNT. THIS FIGURE WOULD THEN BE SUBMITTED TO CONGRESS IN FEBRUARY, 1996 AS PART OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1997. CONGRESS WOULD THEN HAVE UNTIL OCTOBER, 1996 TO MAKE THE CUTS BEFORE A SEQUESTER WOULD BE MANDATED.

THIS ALSO GIVES CONGRESS MORE OPPORTUNITY TO FORESEE THE CUTS AND MAKE INFORMED DECISIONS.

(4)THIS LAST CHANGE IS ONE TO WHICH I ALLUDED EARLIER. ORIGINALLY, I HAD ONLY EXEMPTED THE SOCIAL SECURITY RETIREMENT ACCOUNTS, INTEREST ON THE DEBT AND DEPOSIT INSURANCE FROM THE SEQUESTRATION WHICH WOULD OCCUR IF CONGRESS DID NOT MAKE THE NECESSARY CUTS THEMSELVES. DURING CONSULTATIONS WITH THE HOUSE BUDGET COMMITTEE, WAYS AND MEANS, AND CBO, IT WAS POINTED OUT TO ME THAT THERE WERE SEVERAL OTHER ACCOUNTS WHICH WERE CONTRACTUAL OBLIGATIONS OF THE FEDERAL GOVERNMENT, AND THEREFORE, HAD TO BE FULLY FUNDED. EXAMPLES INCLUDE JUDGES SALARIES AND PAYMENTS RESULTING FROM GOVERNMENT INSURANCE AND GUARANTEES. THESE ACCOUNTS ARE NEGLIGIBLE FINANCIALLY, AND WILL HAVE LITTLE EFFECT ON THE ESTIMATES OF THE MEASURE.

ONE AND THREE HAVE ALREADY BEEN INCORPORATED IN THE BILL. NUMBERS TWO AND FOUR WILL HAVE TO BE ADDED LATER.

THIS MEASURE HAS BROAD SUPPORT. I REINTRODUCED IT ON THE FIRST DAY OF THE 104TH CONGRESS AND NOW HAVE 84 COSPONSORS. SENATOR BOB SMITH WHO IS ALSO TESTIFYING TODAY IS THE LEAD SPONSOR ON THE SENATE SIDE.

I AM THANKFUL TO THE GROWING NUMBER OF ORGANIZATIONS AND INDIVIDUALS WHO HAVE ENDORSED THE TAXPAYER DEBT BUY-DOWN. NORM TURE, PRESIDENT OF THE INSTITUTE FOR THE RESEARCH ON THE ECONOMICS OF TAXATION, PAUL MERSKI OF THE CITIZENS FOR A SOUND ECONOMY, AND TOM SCHATZ FROM THE CITIZENS AGAINST GOVERNMENT WASTE ARE ALL HERE TODAY ON THIS BILLS' BEHALF. OTHERS LONG-TERM SUPPORTERS INCLUDE, LAWRENCE KUDLOW, ECONOMICS EDITOR FOR THE NATIONAL REVIEW, AND THE NATIONAL TAXPAYERS UNION.

PRESIDENT CLINTON INCHED TOWARD THE CONCEPT OF DEBT BUY-DOWN WITH HIS DEFICIT TRUST FUND PROPOSAL. BY ESTABLISHING A PARKING PLACE FOR DEBT REDUCTION AT THE U.S. TREASURY, THE PRESIDENT ACKNOWLEDGED THE NEED FOR AN ACCOUNTING TOOL TO ASSURE THE PUBLIC THAT DEFICIT REDUCTION MONEY WAS TRULY GOING TO DEFICIT REDUCTION.

BUT THE PRESIDENT'S FUND HAS NO LEGS BEYOND ITS ACCOUNTING CLEVERNESS. FOR DEBT AND DEFICITS TO BE REDUCED, THE SPENDING CUT AND SEQUESTRATION MECHANISM OF THE TAXPAYER DEBT BUY-DOWN ARE NEEDED. ONLY THEN CAN CBO AND OMB SCORE REAL SAVINGS.

SEVERAL OTHER POINTS SHOULD BE NOTED FOR A FULL UNDERSTANDING OF THIS PROPOSAL. TAX INCREASES CANNOT BE USED TO OFFSET THE SPENDING CUT DEMANDS MADE BY TAXPAYERS EACH YEAR. WHILE CONGRESS WOULD STILL BE PERMITTED TO RAISE TAXES FOR OTHER REASONS, TAX REVENUES WOULD NOT COUNT AGAINST THE BASELINE REDUCTIONS REQUIRED BY THE BUY-DOWN PLAN. AND, ANY TAX INCREASES ON PERSONAL INCOME WOULD HAVE THE EFFECT OF GIVING TAXPAYERS MORE OF A LIABILITY AGAINST

WHICH TO REQUIRE SPENDING CUTS.

THERE HAS BEEN SOME PUBLIC REACTION TO THE DEBT BUY-DOWN CONCEPT AND THAT REACTION HAS BEEN HIGHLY POSITIVE. PRESIDENT BUSH'S ENDORSEMENT OF THIS IDEA AT THE 1992 REPUBLICAN NATIONAL CONVENTION LED POLLSTERS TO GAUGE PUBLIC OPINION. A POLL DONE FOR THE BUSH CAMPAIGN SHOWED 66% OF AMERICANS SUPPORTING THIS NEW IDEA IN THE SUMMER OF 1992. PUBLIC SUPPORT INCREASED TO 75% IN A NATIONAL OPINION BALLOT DONE IN DECEMBER 1992. IN JUNE, 1993, THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS FOUND 77% OF THEIR MEMBERSHIP FAVORED THE PLAN.

DEBT BUY-DOWN TAKES THE INTRACTABLE ISSUE OF SPENDING CUTS OUTSIDE THE HALLS OF CONGRESS AND INTO THE HOUSEHOLDS OF THE AMERICAN PEOPLE. THEY WOULD HAVE AN OPPORTUNITY NOT ONLY TO HELP DECIDE HOW MUCH CUTTING WOULD BE DONE, BUT THEY WOULD HAVE AN OPPORTUNITY TO HOLD THEIR REPRESENTATIVES ACCOUNTABLE FOR ACTING OR FAILING TO ACT ON THEIR WISHES. AND AT ANY TIME THE AMERICAN PEOPLE BEGAN TO BELIEVE THE SPENDING CUTS HAD GONE TOO DEEP, THEY WOULD HAVE AN ANNUAL OPTION OF NOT ASKING FOR ADDITIONAL REDUCTIONS.

DEBT BUY-DOWN IS A REVOLUTIONARY APPROACH TO A GROWING PROBLEM. THE NATIONAL DEBT PROBLEM HAS GROWN SO LARGE THAT IT DEFIES TINKERING AROUND THE MARGINS. REAL SOLUTIONS ARE GOING TO DEMAND BREAK-THROUGH IDEAS. THE DEBT BUY-DOWN BREAKS THROUGH MANY OF THE PROBLEMS CONNECTED WITH THE DEBT AND DEFICIT BY BYPASSING SPECIAL INTEREST PLEADINGS FOR EVER-LARGER BUDGETS AND GIVING A BROAD SEGMENT OF THE POPULATION A CHANCE TO REGISTER AN ANTI-SPENDING MANDATE EACH AND EVERY YEAR.

EMPTY PROMISES OF FISCAL RESPONSIBILITY ARE NO LONGER ADEQUATE. PUBLIC DISCOURSE WILL DEMAND REAL SOLUTIONS. ONLY BOLD ACTION WILL CONVINCE OUR CONSTITUENTS THAT WE ARE FINALLY PUTTING OUR FISCAL HOUSE IN ORDER. YOU CAN BEGIN THAT ACTION BY APPROVING THE TAXPAYER DEBT BUY-DOWN.

BEFORE I CLOSE, I WOULD LIKE TO BRIEFLY DISCUSS WITH YOU ANOTHER PART OF THE JOB CREATION AND WAGE ENHANCEMENT ACT, WHICH CHAIRMAN ARCHER HAS INTRODUCED AND HAS BEEN REFERRED TO THE COMMITTEE ON SCIENCE, WHICH I CHAIR. THE LEGISLATION IS THE RISK ASSESSMENT AND COST/BENEFIT ANALYSIS FOR NEW REGULATIONS, WHICH IS TITLE III OF H.R. 9.

THE COST OF COMPLIANCE WITH FEDERAL REGULATIONS IS ASTOUNDING - AS LEAST $130 BILLION ANNUALLY FOR ENVIRONMENTAL REGULATIONS ALONE. PRIVATE SECTOR COMPLIANCE COSTS FOR ALL FEDERAL REGULATIONS EXCEED $430 BILLION PER YEAR - 9 PERCENT OF OUR GROSS DOMESTIC PRODUCT, ACCORDING TO THE CLINTON ADMINISTRATION'S OWN NATIONAL PERFORMANCE REVIEW (PAGE 32). IN AN ERA OF TOUGH BUDGET REALITIES, POLICY-MAKERS NEED TO MAKE CHOICES AND SET PRIORITIES -- TO CONCENTRATE SCARCE DOLLARS WHERE THEY WILL DO THE MOST GOOD, AND ANALYZE ALTERNATIVES TO ACHIEVE THE GOAL OF PUBLIC SAFETY AT THE LOWEST POSSIBLE COST.

WITH A STANDARDIZED, UNDERSTANDABLE CALCULATION OF RISKS AND COMPLIANCE COSTS, CONGRESS AND THE PUBLIC WILL KNOW THAT THEIR DOLLARS ARE BEING WELL SPENT - WITHOUT LOWER STANDARDS OF PROTECTION.

THE PURPOSE OF TITLE III IS TO GIVE US THE GREATEST PROTECTION OF PERSONAL HEALTH AND SAFETY FOR OUR EFFORTS, ALLOWING US TO DIRECT OUR RESOURCES TO THOSE PROBLEMS THAT WILL SAVE MORE LIVES. TITLE III IS A SMARTER APPROACH TO FEDERAL REGULATION AIMED AT GETTING OUR MONEY'S WORTH FROM RISK ANALYSIS. IT AIMS AT IMPROVING AND STANDARDIZING THE METHODS FEDERAL REGULATORS USE FOR RISK ASSESSMENT. RISK ANALYSIS SHOULD BE BASED ON UNBIASED SCIENCE, TO ASSURE THEY ARE AS ACCURATE AND OBJECTIVE AS POSSIBLE. THE LEGISLATION ALSO ESTABLISHES RELATIVE RISK REDUCTION AS A PRINCIPAL TOOL FOR SETTING PRIORITIES FOR FEDERAL REGULATIONS.

THANK YOU FOR YOUR TIME AND CONSIDERATION.

Mr. McCRERY. Thank you, Mr. Walker.
Senator Smith.

STATEMENT OF HON. ROBERT SMITH, A U.S. SENATOR FROM THE STATE OF NEW HAMPSHIRE

Senator SMITH. Thank you very much, Mr. Chairman.

I might just say, with no disrespect to my colleagues on the Democratic side, it is nice to say "Mr. Chairman" to a Republican colleague. This is exciting for me.

I want to compliment my colleague, Bob Walker, for getting this in the Contract With America, because it is moving along now in a big package, and that is very exciting. Bob has explained pretty much how it works. I do have a full statement regarding that that I would like to insert for the record and just make a few summary comments.

The midterm elections I think represented a mandate for change; there isn't any question about that. The American people want to be more directly involved in their government. You are seeing a great popularity now in town meetings, in citizen referendum, talk radio, all of these things, and I think the 104th Congress is listening to the people. This is an example of that listening.

We have seen the Congressional Accountability Act, the unfunded mandates bill already passed one body or the other, and the Congressional Accountability Act, both bodies; the balanced budget amendment already passed the House, now on the floor. We have been talking about giving welfare back to the States. This is all very exciting.

Now, the Taxpayer Debt Buydown Act is the same thing, it is the same spirit. It gives people the right to participate. It prevents politicians, whoever they may be in the future, from mortgaging their kids' future. It is a safety valve.

We let taxpayers finance the debt—this is a very interesting point—we let taxpayers finance the debt by purchasing Treasury securities. So why not let them finance deficit reduction by designating a certain percentage of their tax dollars up to 10 percent. The American people deserve that chance. They deserve to show that they are willing to sacrifice. It is their money.

Most Americans feel it is immoral to pass on this debt to future generations, as we do, and this bill will give us a referendum on spending. Congress gets its marching orders from the people. And it is more and more important also if the amendment passes the Senate, which I hope it will do in the very near future and be ratified by the States, that will balance the budget when Congress decides to implement the amendment. But then we have to reduce the debt. It is not enough just to keep the budget balanced.

We will have well over a $5 trillion debt by the time the balanced budget amendment takes effect, and this is a safety valve. This will say that the taxpayers can say, Up to 10 percent of our dollars will be used on reducing the national debt, and of course if it is implemented before that, it would reduce the deficit. But until that time, this is a safety valve, and no matter what the taxpayers, whatever the Congress does, if they say we are going to reduce it by $100 billion and the taxpayers pick $50 billion, so be it. But if the taxpayers pick more than that kicks in, the taxpayers then would dictate how much it should be reduced.

So it is all very exciting, and I am pleased to be a part of it.

Certainly I would be happy to answer any questions, and thank you, Mr. Chairman, for having a hearing on this, what I consider to be a very important piece of legislation.

[The prepared statement follows:]

TESTIMONY ON THE TAXPAYER DEBT BUY DOWN ACT
HOUSE COMMITTEE ON WAYS AND MEANS
SENATOR ROBERT SMITH
FEBRUARY 1, 1995

MR. CHAIRMAN, MR. GIBBONS, MEMBERS OF THE COMMITTEE: THANK YOU FOR GIVING ME THE OPPORTUNITY TO TESTIFY IN SUPPORT OF THE TAXPAYER DEBT BUY DOWN ACT. I AM THE SENATE SPONSOR OF THE BILL AND I AM PROUD TO JOIN BOB WALKER IN THIS EFFORT TO INVOLVE THE AMERICAN PEOPLE IN THE FIGHT TO REDUCE DEFICITS AND PAY DOWN THE DEBT. CONGRESSMAN WALKER HAS ALREADY EXPLAINED IN GREAT DETAIL HOW THE BILL WOULD WORK SO I WOULD LIKE TO FOCUS ON WHY I THINK IT IS SUCH A GOOD IDEA.

MR. CHAIRMAN, THE MIDTERM ELECTIONS REPRESENTED A MANDATE NOT JUST FOR LESS GOVERNMENT BUT ALSO FOR MORE RESPONSIVE GOVERNMENT. THE AMERICAN PEOPLE ARE DEMANDING AN END TO BUSINESS AS USUAL IN WASHINGTON. AS ANYONE WHO HAS HELD A TOWN MEETING RECENTLY, OR WATCHED THE POPULARITY OF CITIZEN REFERENDA SPREAD ACROSS THE STATES, OR TUNED IN TO TALK RADIO KNOWS, THE AMERICAN PEOPLE WANT TO BE MORE DIRECTLY INVOLVED IN <u>THEIR</u> GOVERNMENT. THEY DON'T WANT EVERY DECISION BEING MADE IN A FAR AWAY CAPITOL.

I AM PLEASED TO SAY THAT, THUS FAR, THE 104TH CONGRESS IS LISTENING TO THE AMERICAN PEOPLE. WE ARE LISTENING AND WE ARE GETTING THINGS DONE. WE PASSED THE CONGRESSIONAL ACCOUNTABILITY ACT IN RECORD TIME. AT LONG LAST, CONGRESS WILL BE UNABLE TO EXEMPT ITSELF FROM THE LAWS IT PASSES ON THE PRIVATE SECTOR. IN ADDITION, WE OVERWHELMINGLY PASSED THE BILL MAKING IT HARDER FOR WASHINGTON TO PUT UNFUNDED MANDATES ON STATES AND LOCALITIES.

THESE BIPARTISAN SUCCESS STORIES ARE JUST THE BEGINNING. THAT IS WHY WE ARE LOOKING AT WAYS TO SEND FEDERAL PROGRAMS SUCH AS WELFARE BACK TO THE STATES. THAT IS WHY WE ARE GOING TO HAVE THE FIRST-EVER FLOOR VOTE ON TERM LIMITS THIS YEAR. THE TAXPAYER DEBT BUY DOWN ACT IS IN THAT SAME SPIRIT.

CONGRESSMAN WALKER AND I DEVELOPED THIS LEGISLATION SO THAT WE COULD CREATE AN ACTIVE ROLE FOR "WE THE PEOPLE" IN FISCAL MATTERS OF THE FEDERAL GOVERNMENT. THE TAXPAYER DEBT BUY-DOWN ACT WOULD ALLOW TAXPAYERS TO DIRECTLY PARTICIPATE IN SOLVING THE MOST CRITICAL FISCAL PROBLEMS FACING OUR NATION: THE ANNUAL BUDGET DEFICITS AND THE EVER-INCREASING NATIONAL DEBT.

THIS BOLD LEGISLATION WOULD ALLOW TAXPAYERS TO DESIGNATE UP TO TEN PERCENT OF THEIR INCOME TAX LIABILITY FOR THE SOLE PURPOSE OF DEFICIT REDUCTION. CONGRESS WOULD THEN HAVE TO ENACT THE SPENDING CUTS NEEDED TO EQUAL THE TOTAL AMOUNT DESIGNATED IN ANY GIVEN YEAR BY THE TAXPAYERS. IF CONGRESS FAILED TO ACT, AN AUTOMATIC ACROSS-THE-BOARD SEQUESTER OF ALL GOVERNMENT ACCOUNTS EXCEPT SOCIAL SECURITY, DEPOSIT INSURANCE, CERTAIN CONTRACTUAL OBLIGATIONS, AND NET INTEREST ON THE DEBT WOULD BE TRIGGERED. AGAIN, THERE IS AN ACROSS-THE-BOARD SEQUESTER ONLY IF THE CONGRESS REFUSES TO TAKE ACTION.

I KNOW THAT SOME MEMBERS FEEL THAT ACROSS-THE-BOARD CUTS ARE UNFAIR. HOWEVER, SEQUESTERS ARE NOT NEARLY AS UNFAIR AS

BURDENING FUTURE GENERATIONS WITH MOUNTAINS OF DEBT. AND WE DO NOT HAVE TO HAVE ACROSS-THE-BOARD CUTS. THE ONLY REASON A SEQUESTER WILL OCCUR IS IF CONGRESS DOES NOT HAVE THE GUTS TO STEP UP TO THE PLATE AND PRIORITIZE FEDERAL SPENDING.

UNLIKE MANY PREVIOUS ATTEMPTS TO REDUCE THE DEFICIT, OUR BILL WOULD RESULT IN REAL SPENDING CUTS. THE BUDGET BASELINE WILL BE REDUCED BY THE AMOUNT OF THE CUT; THUS, LASTING DEFICIT REDUCTION IS ASSURED. IT IS THIS PROVISION THAT MAKES THE 10% CHECK-OFF VIABLE BECAUSE FEDERAL SPENDING WILL BE PUT ON A STEADILY DECLINING PATH. MOREOVER, WHILE NOTHING IN THIS BILL PREVENTS CONGRESS FROM RAISING TAXES, TAX HIKES COULD NOT BE USED TO SUBSTITUTE FOR THE SPENDING CUTS DESIGNATED BY THE TAXPAYERS.

THE FEDERAL GOVERNMENT HAS NOT HAD A BALANCED BUDGET SINCE 1969 AND CURRENT PROJECTIONS SHOW HUGE DEFICITS FOR YEARS TO COME. WE HAVE NO CHOICE BUT TO STOP THE SPENDING, STOP THE BORROWING AND PAY DOWN THE DEBT.

TWENTY FIVE YEARS OF DEFICIT SPENDING HAVE LEFT US WITH A NATIONAL DEBT IN EXCESS OF $4.7 TRILLION. EVERY AMERICAN'S SHARE OF THAT DEBT IS AN ASTOUNDING $17,700. AND, DESPITE CLAIMS OF PROGRESS ON THE DEFICIT, WHEN PRESIDENT CLINTON'S SO-CALLED DEFICIT REDUCTION PLAN HAS RUN ITS COURSE, THE NATIONAL DEBT WILL APPROACH $6 TRILLION.

THE AMERICAN PEOPLE KNOW OUR NATION IS IN A FINANCIAL CRISIS THAT CALLS FOR DECISIVE ACTION. THE 10% CHECKOFF WILL GIVE THE AMERICAN PEOPLE THE RIGHT TO DEMAND THAT POLITICIANS IN WASHINGTON STOP MORTGAGING THE FUTURE FOR THEIR OWN POLITICAL BENEFIT.

POLLS SHOW THAT THIS IDEA IS VERY POPULAR WITH THE AMERICAN PEOPLE. HOWEVER, IT IS NOT NEARLY SO POPULAR INSIDE THE BELTWAY. MANY IN WASHINGTON ARE HORRIFIED BY THE NOTION OF GIVING TAXPAYERS MORE SAY IN HOW THEIR MONEY IS SPENT.

WELL, WE ALLOW TAXPAYERS TO DIRECTLY FINANCE <u>DEFICIT SPENDING</u> BY GIVING THEM THE OPTION OF PURCHASING TREASURY SECURITIES. WHY CAN'T WE ALLOW THEM TO DIRECTLY FINANCE <u>DEFICIT REDUCTION</u> BY LETTING THEM DEVOTE A SMALL PORTION OF THEIR TAX LIABILITY TO THE DEFICIT REDUCTION TRUST FUND?

MR. CHAIRMAN, IT HAS BECOME CONVENTIONAL POLITICAL WISDOM THAT THE AMERICAN PEOPLE SUPPORT DEFICIT REDUCTION IN THEORY BUT NOT IN PRACTICE. BUT I AM NOT SURE THAT'S TRUE. I THINK MOST AMERICANS FEEL IT IS IMMORAL TO PASS ON MOUNTAINS OF DEBT TO FUTURE GENERATIONS. I THINK MOST AMERICANS WANT TO PASS ON TO THEIR CHILDREN A NATION OF WHICH THEY CAN BE PROUD. I KNOW THE CITIZENS OF NEW HAMPSHIRE ARE INTENSELY CONCERNED ABOUT THE NATIONAL DEBT.

THE TEN-PERCENT CHECKOFF WILL GIVE US A NATIONAL REFERENDUM ON SPENDING AND THE DEFICIT EVERY APRIL 15TH. WE WILL KNOW HOW THE AMERICAN PEOPLE REALLY FEEL ABOUT IT. THEY WILL GIVE CONGRESS ITS MARCHING ORDERS AND CONGRESS WILL FINALLY CONTROL SPENDING BECAUSE THEY WILL HAVE NO CHOICE.

I THINK THE AMERICAN PEOPLE DESERVE A CHANCE TO SHOW THEY ARE WILLING TO MAKE THE SACRIFICES NEEDED TO SAVE THE COUNTRY.

THAT IS ALL WE ARE ASKING IN THIS LEGISLATION. GIVE THE AMERICAN PEOPLE A CHANCE.

MR. CHAIRMAN, ANOTHER REASON THE DEBT BUY DOWN ACT IS SO APPEALING IS BECAUSE IT IS A GREAT COMPLIMENT TO THE BALANCED BUDGET AMENDMENT. BY THE WAY, I'D LIKE TO CONGRATULATE THE HOUSE FOR PASSING THE BALANCED BUDGET AMENDMENT. THROUGHOUT MY SERVICE IN CONGRESS I HAVE ADVOCATED A CONSTITUTIONAL REQUIREMENT THAT WE BALANCE THE FEDERAL BUDGET. I AM HOPEFUL WE CAN GET IT THROUGH THE SENATE AND SEND IT OFF TO THE STATES FOR RATIFICATION.

IF THE BALANCED BUDGET AMENDMENT IS RATIFIED HARD CHOICES WILL HAVE TO BE MADE TO BRING THE BUDGET INTO BALANCE BY 2002. CONGRESS IS GOING TO HAVE TO SQUARE WITH THE AMERICAN PEOPLE. WE WILL HAVE TO DECIDE WHETHER WE WANT TO SLOW THE GROWTH OF SPENDING, RAISE TAXES OR SOME COMBINATION OF BOTH. I THINK THE NOVEMBER ELECTIONS PROVED THE AMERICAN PEOPLE WANT TO BALANCE THE BUDGET BY HOLDING THE LINE ON SPENDING. THE TAXPAYER DEBT BUY DOWN ACT WILL LET THEM SAY SO LOUD AND CLEAR EVERY APRIL.

IT IS ALSO IMPORTANT TO REMEMBER THAT THE BALANCED BUDGET AMENDMENT DOES NOT GUARANTEE WE WILL BALANCE THE BUDGET EVERY YEAR. IT WILL BE MUCH HARDER TO RUN A DEFICIT BECAUSE MEMBERS OF CONGRESS WOULD HAVE TO SPECIFICALLY VOTE FOR DEFICIT SPENDING. STILL, WITH A SUPER MAJORITY VOTE CONGRESS CAN WAIVE THE BALANCED BUDGET REQUIREMENT AND ADD TO THE NATIONAL DEBT.

THAT DEBT IS A MILLSTONE AROUND THE NECK OF FUTURE GENERATIONS. THAT DEBT IS THE REASON MORE YOUNG PEOPLE BELIEVE IN UFOs THAN BELIEVE THAT SOCIAL SECURITY WILL BE THERE FOR THEM. BY GIVING THE TAXPAYERS THE POWER TO MANDATE SPENDING CUTS THE TAXPAYER DEBT BUY DOWN ACT WILL MAKE IT MUCH LESS ATTRACTIVE FOR CONGRESS TO WAIVE THE BALANCED BUDGET REQUIREMENT. IF CONGRESS IS FORCED BY THE AMERICAN PEOPLE TO SPEND LESS, THERE IS LITTLE CHANCE CONGRESS WILL BE ABLE TO RUN A DEFICIT EVEN IF IT WANTS TO.

THE TAXPAYER DEBT BUY DOWN ACT ALSO PUTS IN PLACE A MECHANISM BY WHICH WE CAN PAY DOWN THE NATIONAL DEBT. THIS IS IMPORTANT BECAUSE THE NATIONAL DEBT WILL NOT DISAPPEAR JUST BECAUSE WE HAVE A BALANCED BUDGET AMENDMENT. IF WE BALANCE THE BUDGET IN 2002, THE NATIONAL DEBT WILL BE IN THE NEIGHBORHOOD OF $6 TRILLION. I THINK THE AMERICAN PEOPLE SHOULD BE GIVEN THE OPTION TO TELL CONGRESS TO START PAYING DOWN THAT $6 TRILLION DEBT.

SO IT'S A PERFECT COMPLIMENT TO THE BALANCED BUDGET AMENDMENT: IT WILL ALLOW THE TAXPAYERS TO MANDATE THAT THE BUDGET BE BALANCED BY SPENDING CUTS; IT WILL MAKE CONGRESS LESS LIKELY TO WAIVE THE BALANCED BUDGET REQUIREMENT; AND, IT WILL HELP US PAY DOWN THE DEBT.

MR. CHAIRMAN, IN CLOSING, I KNOW THIS BILL IS CONTROVERSIAL. BUT, IT IS ALSO REAL, POSITIVE CHANGE. IT IS DEFINITELY NOT BUSINESS AS USUAL. THIS LEGISLATION WILL DIRECTLY INVOLVE THE AMERICAN PEOPLE IN THE FIGHT TO MAKE THE GOVERNMENT LIVE WITHIN ITS MEANS.

AND, IT HAS THE POTENTIAL TO FORCE MEMBERS OF CONGRESS--OF BOTH PARTIES--TO DO WHAT WE SHOULD HAVE BEEN DOING FOR 25 YEARS: NAMELY, REDUCE SPENDING AND BUY DOWN THE DEBT. I URGE THE COMMITTEE TO SUPPORT IT. AGAIN, I THANK THE COMMITTEE FOR LETTING ME TESTIFY AND I'D BE HAPPY TO ANSWER ANY QUESTIONS.

Mr. McCRERY. Thank you, Senator and Representative Walker. We appreciate very much your taking time out to visit with us and explain your legislation.

Mr. Herger, do you have questions of the witnesses?

Mr. HERGER. I just might ask quickly, briefly, how do you see the debt buydown proposal working with the balanced budget amendment? Would the debt buydown proposal assist the budget balancing process as required by the constitutional amendment? And if so, how would the two be coordinated?

Mr. WALKER. Well, I think they work very well together. First of all, this is an implementation tool for the balanced budget amendment. Insofar as we are trying to go from deficit budgets to a balanced budget, for a period of time here you have a mechanism that is helpful to reconciliation.

If in fact we decide in the reconciliation process to get rid of the deficit faster than what the American people have designated, this would have no effect. However, let's say Congress is finding it tougher and tougher to do reconciliation and the American people decide that we ought to be moving faster. They can, through their taxes, tell us that they want us to go faster, and force us to do even quicker implementation of the balanced budget amendment, simply by checking off on their tax forms that they want more to be subtracted from the spending.

I think that sends an important political signal to the Congress, and I think it sends an important economic signal to the country; that the people maybe will be more willing to go faster than the politicians. And then it gives the politicians some cover because we are simply doing that which the American people have told us they want done.

Senator SMITH. If I could give a quick response, I think it is very much an implementing tool as well. I agree with what Congressman Walker says.

If you just use one example, let's say that the taxpayers decide that they want to pay off $20 billion a year and the Congress doesn't want to pay any. Well, even if the taxpayers so decide that, it would take 50 years at $20 billion a year to get—retire $1 trillion of what will probably be a $5 or $6 trillion debt, if we are lucky, by the time we get to the balanced budget amendment and get this thing implemented.

So it is a safety valve. It is very important. It gives the taxpayers the opportunity to set the pace of retirement with, you know, with some restrictions. If Congress goes more or less—but they can't go less. That is the point. They can go more, but they can't go less. I think that is why it is exciting.

I think the taxpayers are going to be very excited about this, especially after the balanced budget amendment becomes law, becomes part of the Constitution. I think they are going to be very excited about being a part of it. Everywhere I have gone in the meetings I have had on this, as I am sure Congressman Walker has found out, there is a lot of excitement about it. Some say, Wow, I can see this; I donate $2,000 and I know it is going right to the debt, it can't go anywhere else. It is empowering.

Mr. HERGER. I thank you very much. That is indeed my experience, as I go around the townhall meetings, people feel a sense of responsibility that we have this huge debt which is on their children and grandchildren, and the excitement of being able to at least do their part, whatever amount that is toward doing away with this debt, again, is very popular, I have found.

So thank you very much. I appreciate it.

Mr. MCCRERY. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

I have had a little bit of problem explaining this, even though I support it. I think Bob especially knows that I have supported it. In fact, you spoke, I think it was last year, to one of the Ways and Means meetings on this subject.

Actually, aren't we in a situation where we are saying what a lot of us who support the balanced budget amendment wanted, and that is a balanced budget amendment with a spending limit slightly under the taxing limit. In other words, aren't we saying here that we are going to balance the budget, but we are going to start reducing the debt; therefore, we are going to actually spend less money than we have coming in, but we are going to leave it up to the people to designate how much money they want to spend of their taxes toward reducing the debt.

Isn't that what you end up with?

Mr. WALKER. Well, I am not certain that it is exactly that. Remember, as long as there is a deficit, what people are doing is they are designating their money to debt buydown, and so we are in fact, spending that money to buy down a debt which presently exists. But the mandate is as long as there is a deficit, that you have to subtract an equal amount of spending.

Now, Congress can either decide to do the job of finding those spending cuts through a reconciliation process or whatever else they want to do, but if they don't do it, then there is an across-the-board sequester to assure that the spending is cut. So, therefore, what you get during the period you have deficits is you have both debt and deficit coming down at the same time.

Now, once you balance the budget, then you get to the situation where any money that people designate to debt buydown is specifically going to buy down the debt instrument of the Federal Government.

Senator SMITH. That is what I like about it. I mean, assuming we are going to get to the balanced budget, because the amendment will force us to do that, it is the ideal follow on technology, if you will. If you want to use an example that Science and Space Committee Congressman Walker chairs, it is "follow on."

We will get there with a balanced budget, but the balanced budget amendment doesn't say how or if or whatever way we are going to reduce the debt. It just gets us to a balanced budget, which theoretically could leave us at a $5.2 trillion debt forever. This says you can reduce it and here is how much you have to reduce it minimally.

Mr. HANCOCK. Well, and this is the point that I wanted to make, I wanted to get on the record, that in effect what this would do is what I mentioned: It would establish a balanced budget, but a spending limit slightly under the amount of the money that we take in. In other words, you would have to spend less money than you are taking in, if, in fact, you are ever going to reduce the debt.

Mr. WALKER. Yes. After you have wiped out the deficit, you are absolutely right, you are absolutely correct. What you have done is you have prioritized the debt buydown at that point and assured that that would always be the first thing that was done. And so you would end up spending less in order to cover whatever obligation the American people have put on you to get rid of the debt.

Mr. HANCOCK. I guess what I am having a little bit of a problem getting into my own head is, quite frankly, how you can actually start reducing the debt before you get the budget balanced. I don't know how you actually start reducing the debt without a balanced budget.

Senator SMITH. You don't. The amendment would deal with the deficit first until the deficit goes away. When the deficit goes away, then the dollars would go toward the buydown of the debt.

Mr. WALKER. But you actually have to have something that the money is going toward. When people designate the money, you actually have to do something with the money that has been designated, the revenue coming in.

What we are doing is using that revenue to buy down debt instruments. That gives you the actual transaction that is taking place. At the same time we are telling the government that it must eliminate spending at that same amount, so that anything that you are doing in terms of buying down debt is offset with spending, and you are not simply pushing up the spending to perhaps levels higher than the debt that you have eliminated.

Senator SMITH. Congressman Hancock, one other point which needs to be mentioned here. A lot of people don't realize it, but when you pay off $1 billion of the national debt, you are reducing the interest payment about $80 million, depending on roughly what you borrow, 8 or 9 percent, 8 percent, $80 billion for every billion we retire we are saving in interest. So it has a tremendous ripple effect on the whole issue.

Mr. HANCOCK. It is too bad that the Congress didn't recognize when it started borrowing this money in the first place, when they borrow $1 billion that they are paying off $80 million interest expense every year or thereabouts.

So thank you very much.

Mr. MCCRERY. Mr. Collins.

Mr. COLLINS. Mr. Chairman, I have no questions. But I do appreciate the two gentlemen coming and sharing their views with us. I think you have a good idea.

Mr. WALKER. Thank you, Mr. Collins.

I had a note here from you about a question that you have that we need to discuss a little bit because I don't know the exact implications, but I will be happy to work with you.

Mr. COLLINS. Thank you very much.

Mr. MCCRERY. Mr. Christensen.

Mr. CHRISTENSEN. Just a brief comment and a question and I would also echo my fellow colleagues' sentiments for you coming by. I have seen this plan, I campaigned on this idea, Congressman, and when I met with you and you explained it to me I thought it made a lot of common sense.

In his comments earlier this morning, our colleague, Mr. Kleczka, pretty much attacked this proposal. One of his statements was the fact that this empowers those above-average earners and gives them more say in how their tax dollars are spent in reducing the deficit and eliminating the debt.

Would you care to comment on that, either one of you?

Mr. WALKER. Well, in my view, what it does is assures that we can prioritize some of the spending cuts. If, in fact, it is relatively high-income people who are designating the money, it does tell you maybe some programs that you ought to look at in terms of eliminating spending. If those people are making it very clear that they want the debt to come down, maybe the subsidy programs that go toward them ought to be some of the ones that we look at for elimination.

On the other side of this is, it is taxpayers who are carrying this burden. I mean, we can point to everybody else in society and suggest that they have an equal right to participate, but the bottom line is that when we place these burdens on society, it is the taxpayers who are being required to carry the interest burden and the debt burden and the deficit burden. And all this says is, since we are giving them that obligation, let's give them some say in how we work our way out of it so that they don't have to carry that burden any longer.

I don't see that as a big threat to the Republic. As a matter of fact, I think that ends up strengthening the Republic.

Senator SMITH. Just as an additional comment, I think this is the old class warfare arguments that our friends on the other side like to use, in classifying people in the haves and the have-nots. I think that really is not the issue. It is the debt, it is the debt that is being reduced by the dollars.

We are not—there is no—those taxpayers have no say in what is being reduced. They cannot choose and say, OK, here is $3,000 that I am going to designate for debt retirement, but you got to take it out of, you know, whatever, Medicaid. That is up to the men and women who are elected by American people to do that.

So I think it is a very weak argument. They use it, but I don't think it really holds water.

Mr. WALKER. The other day our colleague from Massachusetts, Joe Kennedy, made a very eloquent argument on the House floor in favor of the balanced budget amendment saying that the people who have suffered the most as a result of the debt and deficit that we have accumulated have been the poorest in our society. If, in fact, we have an implementation strategy here that allows the American people to become directly involved in solving that problem, it is in fact all Americans, including the poorest Americans, who will benefit from that, and it seems to me a pretty good reason for doing that.

Mr. CHRISTENSEN. Thank you very much.

Thank you, Mr. Chairman.

Mr. MCCRERY. Just a quick question, and I apologize for not having researched this myself. But is there a sunset on this legislation?

Mr. WALKER. Well, there is not a specific sunset. I mean, ultimately at the time that you have wiped out the entire debt, there is no longer a need for the program. But the reality is that it probably should stay in place until you have eliminated the debt, because that is the purpose behind it.

First of all, it eliminates the deficit and then it eliminates the debt. The sunset year is 2008.

Mr. McCRERY. So 6 years following the balanced budget——

Mr. WALKER. If everybody participated and if everything works optimally, you can get there by the year 2008.

Senator SMITH. That is optimal. It is not reasonable to assume that every single taxpayer is going to put 10 percent in. But if I live to see the debt retired as a result of this or any other plan, I will have lived a full life, no matter what year it is. Hopefully that won't be next year.

Mr. WALKER. In fact, I am told, I am looking at the language of the bill here just put in front of me and we say the "amendments made by this section shall cease to have any effect after the first fiscal year during which there is no public debt."

Mr. McCRERY. Very good.

Mr. WALKER. So that is the——

Mr. McCRERY. Well, if we had a war and we had to finance some extra expenditures and create a debt, this bill wouldn't still be on the books and force us to extinguish that debt the next year.

Mr. WALKER. Yes. As a part—this bill is written into the Gramm-Rudman bill, and as I understand it, it allows for this to be set aside in a declared emergency or in the case of war.

Mr. McCRERY. OK. Well, thank you both for your testimony. It is a great idea. I am supposed to be a cosponsor. If I am not, please put me down.

Mr. WALKER. You are a cosponsor. In fact, I have your name as well as several other members of the panel, and I am very grateful for that.

Mr. McCRERY. Thank you very much, gentlemen.

Mr. WALKER. Thank you.

Senator SMITH. Thank you.

Mr. McCRERY. Our next panel is Mr. Ture, from the Institute for Research on the Economics of Taxation; Mr. Merski, Citizens for a Sound Economy; and Mr. Schatz, Citizens Against Government Waste.

Welcome, gentlemen. We appreciate your coming today to share your views with us. Your written testimony will be admitted to the record, and we would like for you to take about 5 minutes each and summarize, if you would, your written testimony.

We will begin with you, Mr. Ture.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. TURE. Thank you, Mr. Chairman.

Please accept my commendations for the committee for providing this opportunity to address title XI of H.R. 9. I think the enactment and implementation of title XI would very likely result in a material slowdown in the growth of Federal spending, and in reduction of the Federal budget deficits, as the two previous witnesses have suggested to you. By tying budget policy more closely to the expressed preferences of individual taxpayers, title XI would substantially improve the Federal budget process and increase the efficiency of the fiscal system.

Most Members of the Congress and their constituents alike deplore Federal budget deficits and the resulting requirement for the Federal Government to borrow some of the savings of households and businesses. Notwithstanding, Federal budget deficits are the rule rather than the exception.

In large part, this anomaly results from the fact that the public as a whole can't tell policymakers how much government they are willing to pay for. On the other hand, individuals with a community of interest in obtaining a particular objective for their benefit often organize to persuade policymakers to authorize government programs on behalf of these individuals. This rent seeking has led to proliferation of government programs and activities and expansion of government spending in the aggregate.

Title XI would go a long way toward resolving this problem. It would impose on policymakers the need for much more careful assignment of priorities among government activities and programs. The result would be pressure to curtail programs for particular interest groups in favor of expenditures on behalf of the public as a whole.

Policymaking for any given fiscal year is also very much the prisoner of spending decisions in the past and of the aversion to cutting back on future spending for programs with established beneficiary constituencies. Baseline projections of existing budget program outlays, not the worthiness of those programs, have for the most part dominated budget decisionmaking.

Title XI provides the equivalent of an annual taxpayer referendum concerning the extent to which Federal Government spending should be reduced below the baseline levels for each fiscal year. It would moreover alter the role of baseline spending projections. These projections would be the base from which taxpayer-mandated spending cuts are to be made rather than the base to which outlays are to be added.

Congressman Walker and Senator Smith have suggested the possible size of the spending cuts that title XI would lead to. Whether taxpayers chose to take little or maximum advantage of this opportunity, the aggregate results would be far more accurate than any other poll conveyed to policymakers of the public's views about the level and growth of total Federal spending.

One objection raised to title XI is that it would allow taxpayers to choose only spending cuts, not spending increases. I believe this objection is without substance.

Many people may believe that the government spends too little on this, that, or the other program, but it strains credulity to think that any significant number of people believe that the Federal Government spends too little in the aggregate. Even if the proposed buydown checkoff were to allow taxpayers to indicate that they want an increase in total spending, and are willing to pay more taxes for it, it is most unlikely that any significant number of people would call for a noticeable increase in aggregate Federal outlays.

Another complaint about title XI is that because they pay so much more income taxes, high-income individuals would exert a disproportionately large influence on total spending. Unless it can be shown, however, that there is a positive correlation between income level and preference regarding total Federal outlays, this complaint is without merit.

Title XI would make an important contribution in improving the content of Federal programs and activities and in reducing the government's use and direction of the economy's production capabilities. Its enactment would significantly enhance fiscal efficiency.

I urge the committee's favorable consideration of title XI.

Thank you.

[The prepared statement follows:]

H.R. 9, Title XI: ENHANCING FISCAL EFFICIENCY

Statement by
Norman B. Ture, President
Institute for Research on the Economics of Taxation (IRET)
to
Committee on Ways and Means
U.S. House of Representatives

February 1, 1995

I am Norman B. Ture, president of the Institute for Research on the Economics of Taxation (IRET). My testimony presents my views, not necessarily those of IRET, about Title XI of H.R. 9, the Taxpayer Debt Buy-Down.

I want to commend the Chairman and the Committee for providing this opportunity to address Title XI. These provisions of H.R. 9, I believe, represent a highly constructive effort to improve the existing federal budget process. Their enactment and implementation would very likely result in a material slowdown in the growth of federal spending and in more constructive federal programs.

By tying budget policy making more closely to the expressed preferences of individual taxpayers, Title XI would substantially improve the federal budget process and increase the efficiency of the fiscal system.

Most members of the Congress and their constituents alike deplore federal budget deficits and the resulting requirement for the federal government to borrow some of the saving of households and businesses. Notwithstanding, federal budget deficits are the rule, rather than the exception. In large part, this anomaly results from the fact that budget policy making for any given fiscal year is very much the prisoner of spending decisions in the past and of the aversion to cutting back on future spending for programs with established beneficiary constituencies. Baseline projections of existing budget program outlays, not the worthiness of those programs, have for the most part dominated budget decisions making, not only impelling excessive expansion of federal spending but also impeding adjustment of spending priorities to the changes in demands for government services that necessarily occur in a dynamic society.

Something must be done to overcome these impairments of the fiscal system. Title XI would meet the requirements for a more efficient fiscal system.

Fiscal Efficiency

In a free society, government budget deficits reflect a fundamental failure of the fiscal system. An efficient fiscal system would provide a volume and composition of government spending programs and activities that conform closely with the public's preferences for the services it wants from its government and the cost it is willing to bear to obtain those services.

Achieving an efficient fiscal system, one that confines government spending to the amount the public is willing to pay for in taxes, requires effective communication between taxpayers and public policy makers. The existing fiscal system suffers from communication breakdown. It operates, therefore, contrary to the preferences of policy makers and the body politic as a whole for getting from rapidly expanding budget outlays and deficits to slower growth, if not actual reduction, in the amount of government spending and much smaller deficits. What is needed is a system that (1) allows policy makers to hear the demands of the constituency as a whole for less government spending and smaller deficits, and (2) effectively satisfies these demands.

Title XI enables every individual income taxpayer to communicate explicit instructions to the executive branch and to the Congress to reduce aggregate budget outlays by as much as 10 percent of individual income tax liabilities. Title XI provides the equivalent of an annual taxpayer referendum concerning the extent to which federal government spending should be reduced below the baseline levels for each fiscal year. Moreover, the referendum would mandate the Congress to enact these reductions.

Title XI would not impose on taxpayers the impossible task of specifying which government programs are to be cut back by how much from the spending levels they would otherwise reach. Instead, the Congress would have to order the priorities of existing and new spending programs subject to the overall outlay constraint specified by individual income taxpayers. Only if the Congress failed to bring aggregate spending authorizations within the limits set by the buy-down would an across-the-board sequestration take effect.

One of the great virtues of Title XI is that it would alter the influence of baseline spending projections on budget policy making. The projections would serve as the base from which the taxpayer-mandated reductions are to be made, rather than as that to which outlays are to be added.

Expected Results of Implementing Title XI

The enactment of Title XI would very effectively open the lines of communication between taxpayers and policy makers, informing budget makers by how much taxpayers want spending for the coming fiscal year to be reduced from the projected baseline amount. Whether taxpayers chose to take little or maximum advantage of this opportunity, the aggregate results would far more accurately than any other poll convey to policy makers the public's views about the level and growth of total federal spending.

Congressman Walker and Senator Smith have spoken to the subject of the possible budget effects of Title XI, and I have little to add to their statements on this matter. The specific magnitudes of the budget results, in one sense, would be less consequential than what the results would reflect — a measure of what taxpayers generally wish in terms of aggregate levels of government services. As such, these results would also depict a major achievement in enhancing fiscal efficiency.

Criticisms of Title XI

I want to examine two of the objections that have been raised to Title XI. One of these is that the proposed buy-down check-off is one-sided — it would allow individual taxpayers to opt only for less total spending and deny them the opportunity to choose more total federal outlays. The other objection is that upper-income individuals who pay the most taxes, not the public as a whole, would dictate by how much federal spending as a whole must be reduced.

"The Debt Buy-Down Is a One-Way Street" Objection

The objection that the proposed debt buy-down is asymmetrical — that it offers taxpayers the opportunity to call for a cut in federal spending but no chance to ask for increases in federal outlays — is without real substance. It strains credulity to believe that any significant number of people believe that total federal spending is too low or that total federal spending should be greater.

There are to be sure, many individuals who very much want the federal government to undertake programs or activities on their behalf. Very often, individuals with a community of interest in obtaining a particular objective for their benefit form organizations dedicated to persuading policy makers of the worthiness of the organization's objectives and of the desirability of authorizing government programs and activities to achieve them. What these groups are seeking, of course, are benefits that they are unwilling or unable to obtain by their own efforts or for which they are unwilling themselves to pay.

All public policy makers are familiar with this "rent seeking" which has become the hallmark of our times. It is responsible for the enormous proliferation of government programs and activities aimed at benefitting specific groups in the population rather than the population as a whole. This same proliferation accounts in significant measure for the expansion of aggregate federal spending.

These rent-seeking groups have no concern about the implications of the success of their efforts for the total size of the government, nor do they want expansion of government as a whole. They want, instead, initiation and expansion of activities and programs to serve their particular interests. Even if the proposed debt buy-down check-off were to allow taxpayers to indicate that they want an increase in total government spending, it is highly unlikely that any significant number of people would call for any significant increase in the aggregate amount of federal outlays.

There is, accordingly, no reason to provide any such symmetry in the proposed check-off. The problem that the nation confronts is certainly not that people have no way to get government to hear and to address their demands for government services or benefits. The problem is precisely the reverse — that policy makers are continuously exposed to intensive pressures to add new programs and activities and to expand existing ones on behalf of one or another organized rent-seeking group. And except on rare occasions, policy makers confront no broad-based, organized efforts by the public as a whole to reduce total government outlays, to cut back government programs and activities in general.

The proposed debt buy-down affords individual income taxpayers as a whole the opportunity they do not now have to direct and require policy makers to reduce aggregate government spending. The debt buy-down, moreover, allows the taxpaying public to avoid the maneuver that some policy makers fall back on to finesse calls for less government spending, to wit, "Tell us what specific spending programs you want us to cut."

Individuals can't be expected to name specific spending programs that should be cut. Few, if any of us, are able to identify specific spending programs now in the federal budget. There are probably many individuals who are convinced that the federal government's spending on education, for example, is nonproductive if not, indeed, counterproductive, but it is doubtful that any but a handful of those individuals could identify any specific education program and the amount of its outlays. There is probably a vastly larger number of individuals who are convinced that the federal government is much too large and who do not really much care what programs are curtailed in the interests of greatly reducing the government's presence in our daily lives.

It is not reasonable to ask the public to specify which activities and which programs are to be cut back if aggregate federal outlays are to be reduced. Fortunately, Title XI doesn't make this demand on the public but on the policy makers who are elected with the specific responsibility of making decisions about how much of what government should do.

There is a broadly-based consensus, reflected in the support for a balanced budget amendment, in favor of limiting total federal spending to the amount of taxes people are prepared to pay for government activities. This is a wholly appropriate but nonetheless elusive goal of budget policy. Achieving that goal will require imposing severe limits on initiating or continuing government programs and activities for the benefit of particular groups and particular interests in our society. Government spending, instead, must be concentrated on activities and programs that can be shown to provide benefits for the public as a whole and that exceed the costs they impose.

Title XI will make an important contribution in this respect. By imposing substantial constraints on total spending growth, it will exert continuing, significant pressure on policy makers as a group to set priorities among all the contending program and activity claims that each of them advances. The result is likely to be not only slower growth of government and its reduced presence in people's daily lives but government programs and activities that better meet the demands of the public as a whole.

"The Rich Would Have Too Large a Say in Spending Cut Backs" Objection

Under Title XI, the larger is the amount of an individual's income tax liability, the greater is the amount that the individual can check off for buying down the federal debt and reducing federal spending. The objection that has been raised, not unexpectedly, to this is that it would be unfair to allow people paying substantial amounts of income taxes, i.e., rich people, to exert undue, disproportionate influence over total federal spending — to outvote the poor who pay little in income taxes. But one should ask why it is unfair for those who pay a large amount of income taxes to defray the costs of government to have a larger voice concerning how much the government spends than those who pay little or no income taxes? Indeed, isn't it, instead, unfair for people who pay very little or nothing for the services of government on their behalf to insist that the voices of those who pay for those services should be muted?

The implication, clearly, is that people paying a lot of federal income taxes want the government to do less while people who pay little income tax want the government to spend more. It's difficult to identify any basis for this difference in viewpoint, in the abstract, and it's highly doubtful that there is, in fact, any such income-based difference in preference.

This does not gainsay that people at any taxable income level are likely to oppose cutbacks in government programs of which they are the beneficiaries. As noted above, however, this desire for the government to maintain or enlarge programs on one's behalf doesn't mean one prefers higher amounts of government activities and spending.

Title XI's Contribution to Long-Term Improvement in Budget Policy

The Bipartisan Commission on Entitlements and Tax Reform has performed an invaluable service in alerting the nation to the looming fiscal catastrophe that will overtake us if entitlement spending growth is not materially slowed or tax revenues enormously increased. Reasonable projections of existing law entitlement outlays and tax revenues show that within a generation's time entitlement spending alone will take up every dime of federal revenues. The resulting budget deficits will be in the range of 15 to 20 percent of GDP, and federal borrowing will preempt all of the nation's saving, leaving no saving to finance capital formation. These results foretell a shrinking economy, one in which the living standards of the growing American population will fall at a significant rate.

Even if one substantially discounts these projections of fiscal crisis, prudence dictates that budget policy must very soon turn to putting the brakes on federal spending growth, particularly of entitlement programs. Title XI has the great virtue of giving the public at large the opportunity to fortify policy makers' resolve to address these budgetary difficulties. I urge this Committee's favorable consideration of Title XI of H.R. 9.

Mr. HERGER [presiding]. Thank you very much, Mr. Ture.
Mr. Merski.

STATEMENT OF PAUL G. MERSKI, DIRECTOR, TAX AND BUDGET POLICY, CITIZENS FOR A SOUND ECONOMY

Mr MERSKI. Thank you, Mr. Chairman and members of this committee.

My name is Paul Merski. I am here on behalf of the 250,000 members of Citizens for a Sound Economy. Our members throughout the country have fought long and hard to reduce deficit spending and to bring down our national debt burden.

We give full support to the Taxpayer Debt Buydown Act, a proposal that would empower taxpayers directly to help reduce the national deficit and bring down the debt. Our 250,000 members were instrumental in helping to pass the balanced budget amendment in the House last week.

We believe that the passage of the balanced budget amendment would give even greater urgency to passing sensible proposals like the Taxpayer Debt Buydown Act to help ensure that a balanced Federal budget will become a reality.

Understandably, the American taxpayer has become increasingly frustrated at the inability of policymakers to halt the trend of Federal spending and higher taxes. I believe we clearly witnessed voters venting this frustration this past November 8. Most previous attempts to reduce the deficit and bring the budget into balance has met with little success. So, in order to bring fiscal sanity to the budget process and to lower our national debt, new thinking and new ideas are needed.

Including the 1993 Budget Act signed into law by President Clinton, there have been no less than six major budget deals enacted over the past decade that promised taxpayers a reversal in the trend of deficit spending and a path to a balanced Federal budget.

While it may be too early to see the full results of President Clinton's budget deal that included a record $248 billion tax hike, the failure of similar attempts to reduce the deficit are quite clear.

Under the guise of deficit reduction, combinations of major tax hikes and promised spending cuts were agreed to by Congress in 1982, 1984, 1985, 1987, 1989, 1990, and 1993. Each and every time the results were the same: Greater tax burdens, increased spending and persistent deficits.

Congress' own frustration with persistent budget deficits was vented with the passage of the original Gramm-Rudman-Hollings act in 1985. Unfortunately, even GRH was subverted by Congress and has since been superseded by other legislations. Taxpayers were left with higher taxes, and little deficit reduction to show for it.

While taxpayers may feel betrayed and helpless in their attempt to reduce deficit spending, the Taxpayer Debt Buydown Act—or the 10 percent checkoff—on their tax form would provide them with a unique opportunity to become directly involved in reducing deficit spending if Congress cannot. All taxpayers by the means of a simple checkoff on their tax return could dedicate up to 10 percent of their tax liability specifically toward the payment of the Federal budget deficit and to bring down the debt.

The uniqueness of the 10 percent checkoff approach to deficit reduction is that it breaks from the traditional call of more tax revenues that have in the past actually fostered spending increases rather than reductions. The taxpayer 10 percent checkoff would not represent any new tax liability or burden; it is simply a matter of voluntarily choosing anywhere between 1 and 10 percent of your existing tax liability to reduce the deficit and debt.

I think taxpayers could at last directly enforce the discipline on Washington that it hasn't seen in quite a while.

In the current budget situation, tax revenues intended to go toward deficit reduction can simply be spent. But under provisions in the Debt Buydown Act, the revenues taxpayers designate to reduce the debt cannot lead to increased spending. It would be placed in a debt retirement trust fund and, most importantly, would mandate an equivalent amount of real spending reductions.

Let me just say that I think there is plenty of room for additional spending cuts in our $1.6 trillion budget. Despite the claims by many lawmakers that there will be draconian cuts, because of deceptive baseline budgeting, we will be spending more each year over the next several years than we are in the current fiscal year.

In addition to the balanced budget amendment, we also support a Presidential line-item veto. Those two proposals, with the Taxpayer Buydown Act, provide simple and reasonable solutions that would allow taxpayers the ability to get our fiscal house in order.

Thank you.

[The prepared statement follows:]

Testimony of

Paul G. Merski
Director of Tax and Budget Policy

Citizens for a Sound Economy

before the

Committee on Ways and Means
United States House of Representatives

on

The Taxpayer Debt Buy-Down Act

February 1, 1995

Mr. Chairman and Members of this Committee, thank you for the opportunity to speak before you today. My name is Paul Merski, and I am here on behalf of the 250,000 members of Citizens for a Sound Economy (CSE), a non-profit, citizens group formed in 1984 to develop market-based solutions to public policy problems.

Our members throughout the country have fought long and hard to help reduce federal deficit spending and to bring down our national debt burden. We give full support to the Taxpayer Debt Buy-Down Act, a proposal that would empower taxpayers directly to help reduce the national deficit and debt by reducing federal spending instead of increasing taxes. Our 250,000 members were instrumental in helping pass the Balanced Budget Amendment in the House just last week. We believe that the passage of a Balanced Budget Amendment gives greater urgency to passing sensible proposals like the Taxpayer Debt Buy-Down Act to help ensure that a balanced federal budget will become a reality.

Introduction

Understandably, the American taxpayer has become increasingly frustrated at the inability of policymakers to halt the trend of federal deficit spending and higher taxes. I believe we clearly witnessed voters venting this frustrations this past November 8th. Previous attempts to reduce deficit spending and balance the budget have met will little success.

To bring fiscal sanity to the budget process and to lower our nation's debt, new thinking and new ideas are needed. Including the Omnibus Budget Reconciliation Act of 1993 signed into law by President Clinton), there have been no less than six major budget deals enacted over the past decade that promised taxpayers a reversal in the trend of deficit spending and a path to a balanced federal budget. While it may be too early to see the full results of President Clinton's recent budget deal that included a record $248 billion tax hike, the failures of similar attempts to reduce the deficit are quite clear.

Under the guise of deficit reduction, combinations of major tax hikes and promised spending cuts were agreed to by Congress in 1982, 1984, 1985, 1987, 1989, 1990, and 1993. Each and every time the results were the same: greater tax burdens, increased spending, and persistent deficits. Congress' own frustration with persistent budget deficits was vented with the passage of the original Gramm-Rudman-Hollings Act (GRH) in 1985. GRH contained an automatic sequester mechanism that was intended to cut spending even when Congress could not.

Unfortunately, even this seemingly fool-proof mechanism was subverted by policymakers when an actual $16 billion sequester would have been triggered in 1989. The sequester was simply replaced by a new budget deal that allowed Congress to avoid any tough spending cuts, raise taxes, and stretch out the balanced budget target date further into the future. The budget controls in GRH were further weakened and eventually eliminated by subsequent budget deals that left taxpayers with higher tax burdens and little if any deficit reduction to show for it.

The history lesson of the "budget deal" approach to deficit reduction is clear. Tax increases matched with promised spending cuts have not reduced the deficit over the long term. Inevitably, the promised spending cuts either never materialize or are offset by new spending increases in the budget. Unfortunately, President Clinton's 1993 budget deal once again paired immediate tax hikes (even retroactive tax hikes) with the promise of major spending cuts in the future. However, as history has proven, the only spending cuts that can be counted on are reductions in the budget authority of the current fiscal year, not promised future reductions from increased spending baselines four or five years down the road.

Taxpayers' Recourse

While taxpayers may feel betrayed and helpless in their attempt to reduce deficit spending, the Taxpayer Debt Buy-Down Act (the 10-percent checkoff) would provide them with a unique opportunity to become directly involved in reducing deficit spending if Congress cannot. All taxpayers, by means of a simple checkoff on their tax return, could dedicate up to 10 percent of their tax liability specifically toward the payment of the federal budget deficit.

When the deficit is paid down and the budget is balanced, the funds would then go to reducing the national debt, which is now well over $4.5 trillion and growing. It's a simple fact, until deficit spending is completely eliminated, the national debt will only continue to grow. Currently, one of every seven dollars taxpayers send to Washington must be spent just to pay the interest on our national debt.

The uniqueness of the 10-percent checkoff approach to deficit reduction is that it breaks from the traditional call for more tax revenues that have in the past actually fostered spending increases rather than reductions. The taxpayers' 10-percent checkoff would not represent a new tax liability or burden. It is simply a matter of voluntarily choosing anywhere between 1 and 10 percent of your existing tax liability to help reduce the deficit and debt.

For example, a taxpayer with a $5,000 income tax liability could designate up to 10 percent (or $500) of his taxes to go directly to deficit reduction. The key is that it is a voluntary proposal that lets taxpayers decide themselves the importance of deficit reduction. It is an empowerment issue on the part of the taxpayer. Nothing is mandated until taxpayers designate it by exercising their checkoff option. No lawmaker could be accused of cutting spending against the will of the taxpayer.

Spending Control With Teeth

Taxpayers have repeatedly endured tax increases paired with the promise of future spending cuts that never materialize. That's because there is nothing to stop the new revenues from simply being spent on new or existing federal programs. However, the 10 percent checkoff proposal also provides the means to achieve real spending reduction. By checking off an amount to go toward debt reduction, each individual taxpayer would simultaneously authorize a corresponding dollar-for-dollar reduction in federal spending, except for spending on Social Security, mandatory interest payments on the debt, federal deposit insurance, and other contractual obligations of the federal government.

After the April 15 tax return deadline, the Treasury Department would be required to provide Congress with an estimate of the total amount of money taxpayers have designated to go towards debt reduction. Congress would have more than a year to make any needed spending reductions before a sequester would be mandated. This would enforce taxpayers' wishes that Congress uses the money to both reduce government indebtedness as well as federal spending growth.

If Congress fails to make the designated amount of spending cuts called for by taxpayers, the automatic across-the-board cut (sequester) would kick in. Social Security, net interest, and deposit insurance spending would be exempt. Tax increases would not be allowed to substitute for the required sequestration.

Taxpayers could at last directly force fiscal discipline on Washington. In the current budget situation, tax revenues intended to go toward deficit reduction can simply be spent. But, under the provisions in the Debt Buy-Down Act, the revenue taxpayers designate to reduce the debt cannot lead to increased spending. It would be placed into a debt retirement trust fund and, most importantly, would mandate an equivalent amount of real spending reduction.

This process would repeat each year, further reducing the deficit as well as the spending baseline. The legislation is intended to make spending reductions permanent. A program would be prevented from returning to its previous spending level after a sequestration.

The exact amount of debt reduction that taxpayers would check off cannot be easily estimated since there is insufficient information on how many taxpayers would participate, at what level between zero and ten percent would they choose, and for how long they would participate. However, the Congressional Budget Office has calculated the full deficit reduction potential of the plan illustrating a budget surplus in five years. For example, income tax revenues for 1994 are estimated to be $531 billion. Therefore, the maximum amount that can be dedicated to deficit reduction and matching spending cuts would be $53.1 billion (10% of $531). Additionally, this single year's spending reduction would generate savings in all future years, as programs are barred from returning to previous spending plans. Therefore, even a relatively modest level of participation in the checkoff plan can generate significant future savings as the baseline spending level is reduced.

Plenty Of Room For Savings

Clearly, there is plenty of room for additional spending cuts in a $1.52 trillion per year federal budget. Despite the claim by many lawmakers that draconian spending cuts would be needed, deceptive baseline budgeting currently allows policy makers to spend more, not less, each year while claiming spending has been cut. In the current fiscal year the federal government will spend an estimated $1.52 trillion (which most Americans believe is too high) but, by the year 2000, federal spending will have risen to $1.93 trillion.

While many policymakers are pressured to preserve and increase spending by the multitude of well-organized, well-funded, special-interest groups, the spending cuts demanded by taxpayers themselves under the 10-percent checkoff plan may provide the pressure needed to make a real dent in deficit spending.

Even with a Constitutional Balanced Budget Amendment, additional controls on the federal budget process are needed to ensure taxpayers that the chronic deficit spending situation will improve. In addition to the Balanced Budget Amendment and the 10-percent checkoff plan, CSE's members also support granting line-item veto authority to the President as viable means to control deficit spending.

Taxpayers who just experienced two major federal tax hikes in 1990 and 1993 should at least be granted the ability to help make sure that the deficit reduction promised them is achieved. For Americans to be able to continue increasing their standard of living, government taxing and spending cannot continue to consume a larger and larger portion of their economic efforts. It is devastating to allow the growth rate of the federal debt to outpace our economic growth rate. Many Americans know the effects of running up credit cards and struggling just to pay the interest cost and balance. Taxpayers must balance their checkbooks and they demand now more than ever that elected representatives balance the federal budget books as well. The Taxpayer Debt Buy-Down Act provides a simple and reasonable solution that would allow taxpayers the ability to help get our nation's fiscal house in order.

I thank the Committee for allowing me to testify and would be glad to answer any questions you may have.

Mr. HERGER [presiding]. Thank you very much, Mr. Merski.
Mr. Schatz.

STATEMENT OF THOMAS A. SCHATZ, PRESIDENT, CITIZENS AGAINST GOVERNMENT WASTE

Mr. SCHATZ. Thank you very much, Mr. Chairman.

I appreciate the opportunity to appear before this committee today. My name is Tom Schatz, and I represent the 600,000 members of Citizens Against Government Waste.

In 1993, I testified before the Ways and Means Subcommittee on Select Revenue Measures concerning the Taxpayer Debt Buydown Act, and we greatly appreciate its inclusion in the Contract With America and the legislation that you are considering today.

CAGW supported Representative Walker's and Senator Smith's legislation then, and we continue to believe it represents a real change in the power base in this country. Since Congress has not done its job, it is time for those most directly affected to have their say.

In 1993, I commented to the Subcommittee on Select Revenue Measures that taxpayer agitation and anger is extremely high, but it has not peaked. It may have peaked on November 8, 1994. The message was sent and it must be heeded.

Taxpayers are looking for a plan from the 104th Congress to reduce the deficit, pay down the debt, avoid higher taxes, and regain some control over how Washington spends their money. The Taxpayer Debt Buydown Act allows individual taxpayers to check off a box on their tax return and designate up to 10 percent of their tax liability to a public debt reduction fund to buy down the public debt.

To ensure the contributions to the fund are not offset by higher outlays, the buydown would be matched by equivalent across-the-board spending cuts in all programs except Social Security retirement benefits, interest on the debt, deposit insurance, and a few other minor contractual obligations of the Federal Government.

The true test for the new Congress is to pass meaningful legislation that will once again connect American workers with the government they elect and give them greater control over what is spent. After all, it is their money.

As Mr. Walker noted, both OMB and CBO agree that full participation in the checkoff would balance the budget in 6 years and zero out the debt by fiscal year 2008.

The consequences of failing to eliminate deficits and the debt are devastating. Under current projections, there would be a $12 trillion national debt in 2008; in fiscal year 2012, interest payments and entitlements will eat up all government revenues.

Why is CAGW committed to the Taxpayer Debt Buydown Act? Mr. Chairman, the unchecked growth of public debt and deficits is slowly smothering America's economic strength. This is America's 26th year of unbalanced budgets and recordbreaking deficits. This should not be par for the course.

First, the total debt for liabilities, contingencies and financial obligations for government at all levels may be as high as $17 trillion. This is a number that boggles the mind. It is almost incomprehensible. It is also a number that will continue to grow over the next 5 years no matter what we do to balance spending or balance the budget.

At the Federal level, the national debt of $4.7 trillion today will be more than $6 trillion at the end of fiscal year 1998. Gross interest on the debt, $320 billion in fiscal year 1994, will also continue to rise, reaching, according to CBO calculations, $407 billion in 1998. And if the projections are wrong, and deficits and interest rates are greater, we may be looking at interest payments far greater than that amount.

Mr. Chairman, under any scenario, in the next 15 years or so this country is facing near bankruptcy if we do not address our massive debt and interest payments.

What happens when you cannot repay your debt? For example, if you had four Argentine pesos in 1946, and you had put one in your pocket, do you know how many pesos it would equal today for that single piece of currency? Two point three trillion pesos. In Brazil, you would get 800 to 900 billion pieces of currency for a 1946 coin. People may say this is the United States and we cannot suffer hyperinflation. Argentina was the flagship of South America in 1946 and now the country lies in financial ruins.

This legislation deserves a chance to succeed. The House of Representatives took a major step forward last week by overwhelmingly passing the balanced budget amendment. This week the Senate will begin to debate the balanced budget amendment. Americans know that trimming here and there does not work anymore. The stakes are too high.

When I testified on this bill several years ago some members of the Select Revenue Measures Subcommittee called it irresponsible. We think it is irresponsible to fail to balance the budget and pay down the debt. It is irresponsible to tell the American people that government will collapse, when even with maximum taxpayer participation in the buydown plan, outlays would continue to increase. And it is irresponsible to fail to reorder spending priorities and eliminate nonessential programs in order to eliminate deficits and the debt.

Mr. Chairman, we need to trust the American people to make decisions that have not been made inside the beltway. It is immoral to pass on a massive debt to the next generation and ruin their standard of living. That is why we support the Taxpayer Debt Buydown Act, which would, for the first time, place into the hands of those people who bear the burden of the national debt the power to pay it back. It is time to get it done.

Thank you.

[The prepared statement follows:]

Testimony of
Thomas A. Schatz
President of Citizens Against Government Waste
before the
House Ways and Means Committee
February 1, 1995

Good Afternoon, Mr. Chairman. Thank you for the opportunity to appear before this committee today. I would ask that my written statement be entered into the record.

My name is Tom Schatz and I represent the 600,000 members of Citizens Against Government Waste (CCAGW). In 1993, I testified before the Ways and Means Subcommittee on Select Revenue Measures concerning the Taxpayer Debt Buy-Down Act. CAGW supported Rep. Walker's (R-PA) and Senator Bob Smith's (R-NH) legislation then and we continue to believe it represents a real change in the power base in this country. The Taxpayer Debt Buy-Down Act would shift from legislators to taxpayers the ability to reduce the deficit and debt. Since Congress has not done the job, it's time for those most directly affected to take over.

CAGW was created 11 years ago after Peter Grace presented to President Ronald Reagan 2,478 findings and recommendations of the Grace Commission (formally known as the President's Private Sector Survey on Cost Control). These recommendations provided a blueprint for a more efficient, effective, less wasteful, and smaller government.

Since 1986, the implementation of Grace Commission recommendations has helped save taxpayers more than $250 billion. Other CAGW cost-cutting proposals enacted in 1993 and 1994 will save more than $100 billion over the next five years. CAGW has been working tirelessly to carry out the Grace Commission's mission to eliminate government waste.

In 1993, I commented to the Ways and Means Subcommittee on Select Revenue Measures that "taxpayer agitation and anger is extremely high, but it has not peaked." On November 8, 1994, the people's frustration reached a new level. A message was sent, and must be heeded.

Every year, working Americans see the first five months of their hard- earned dollars given to local, state, and federal taxes. For many, taxes at all levels eat up 40 percent or more of their gross income. That's more than enough. They do not want the deficit reduced with increased taxes.

Taxpayers also feel disconnected to Washington. They are not in charge and they are not truly empowered. The true test for the new Congress is to pass meaningful legislation that will once again connect American workers with the government they elect and give them greater control over what is, after all, their money.

The purpose of today's hearing is to discuss the Taxpayer Debt Buy-Down Act (Title XI of H.R. 9, "The Job Creation and Wage Enhancement Act"), to establish a debt reduction trust fund in the Department of the Treasury, into which up to 10% of an individual's income tax liability would be deposited to help pay off the national debt through a check-off on tax returns. This is a simple, revolutionary, and essential idea with huge consequences.

Both OMB and CBO agree that full participation in the check-off would balance the budget in six years, and zero out the debt by fiscal year 2008. The consequences of failing to eliminate deficits and the debt are devastating: under current projections, in fiscal year 2012, interest payments and entitlements will eat up all government revenues.

President Clinton told the American people last week that many courageous members of Congress who voted for his deficit reduction package in 1993 were voted out of office. What the president failed to tell us is that the 105th and 106th Congresses will have to vote to implement over 80% of those cuts -- so much for courage. Politicians so far have just not been up to the challenge. The cradle-to-grave mentality of big brother government has penetrated deeply into Washington's psyche -- there needs to be another check and balance from the taxpayer.

Why is CAGW committed to the Taxpayer Debt Buy-Down Act? This is America's 26th year of unbalanced budgets and record-breaking deficits. First, the total debt for liabilities, contingencies, and financial obligations for the U.S. government is $17 trillion. This is a number that boggles the mind; it's almost incomprehensible. It's also a number that will continue to grow over the next five years. At the federal level, the national debt of $4.7 trillion today will be more than $6 trillion at the end of fiscal year 1998.

Gross interest on the national debt, $320 billion in FY 1994, will continue to rise, reaching, according to CBO calculations, $407 billion in 1998. If the projections are wrong, and deficits and interest rates are greater, we may be looking at interest payments twice that amount, or more than $800 billion.

Mr. Walker testified earlier that on our current path, the debt will exceed $12 trillion in FY 2008; at 6% interest -- a modest historic average -- that's a payment of $780 billion. Could it happen 10 years earlier? Why not? Did anyone think interest rates would be more than 18% in the late 1970s? Just as a point of information, 18% of $6 trillion is nearly $1.1 trillion.

Mr. Chairman, under any scenario in the next 15 or so years, this country is facing bankruptcy without addressing our massive debt and interest payments.

What happens when you can't repay your debt? For example, if you had four Argentine pesos in 1946, and you had put one in your pocket, do you know how many you would get today for that single piece of currency? 2.3 trillion pesos. In Brazil, you would get 800-900 billion pieces of currency for a 1946 coin. People may say, "this is the United States, we can't suffer hyperinflation." Argentina was the flagship of South America in 1946 and now the country lies in financial ruins.

This legislation deserves a chance to succeed. The House of Representatives took a major step forward last week by overwhelmingly passing the Balanced Budget Amendment (BBA). This week the Senate will begin to debate the BBA. If we are serious about balancing America's budget, we need <u>all</u> ideas of reform and spending cuts out on the table and moved forward quickly by Congress. Americans are savvy enough to recognize we are in a fiscal time-bomb. Trimming here and there does not work anymore. The stakes are too high.

The last time I testified on this bill, some members of the House Ways and Means Subcommittee on Select Revenue Measures called the Walker-Smith bill "irresponsible." I object. It's the height of irresponsibility to fail to balance the budget and pay down the debt. It's irresponsible to have failed to balance the budget since 1969 while running up a $4.7 trillion national debt. It's irresponsible to tell the American people that government will collapse when even with maximum taxpayer participation in the Buy-Down plan, outlays would continue to increase. It is irresponsible to predict the collapse of government on funding levels which are higher that those that we have today. And it is irresponsible to fail to reorder spending priorities and eliminate non-essential programs in order to eliminate deficits and the debt.

Is Congress really more responsible than the American people? Do we not trust them to make decisions that have not been made inside the Beltway? What about the morality of passing on a massive debt to the next generation and ruining their standard of living? Do opponents of the Buy-Down Act plan to balance the budget with massive tax increases, which have not proven effective in the past?

Mr. Chairman, the Taxpayer Debt Buy-Down Act would, for the first time, place into the hands of those people who will bear the burden of the national debt the power to pay it back. It's time to get it done.

Some have raised the question of how reduced participation in the presidential taxpayer check-off program would affect interest in the debt buy-down check-off. Very simply, Mr. Chairman, taxpayers would be far more likely to check a box that saves them money rather than one that costs them money.

It is time to clean up Washington. It is time to stand up to the special interests that will claim their programs can't be cut. It is time to recognize that the only way to help our children and grandchildren is to enact a plan to eliminate the massive debt that will ruin their futures.

The Taxpayer Buy-Down Act will let the real owners of this country, the taxpayers, do just that. I would be happy to answer any questions.

Mr. HERGER [presiding]. Thank you very much for your testimony, Mr. Schatz.

Mr. Ture, if you could maybe comment, with the public expecting Congress to balance the budget with the passage of the constitutional amendment, would you expect any change in the checkoff participation rate?

Mr. TURE. You know, I suspect that the effect on the checkoff rate would probably be positive if a balanced budget amendment passes the Senate as well as the House.

I think that people would see that there really is some determination on the part of the Congress, and one would hope on the part of the States, to bring the Federal Government's fiscal affairs in order. And I think it would focus their attention on their ability to communicate to you and your colleagues, Here is what we would like to see happen.

They do not have that—there is no way in which they can provide that communication today. You can have some of your constituents come in and tell you about how delightful this, that, or the other program would be on their behalf, and they may or may not persuade you. But you cannot get your constituency as a whole to come in and say, We think you are spending too much. They do not have a vehicle for expressing that to you, except perhaps as they did last November.

Give them an opportunity to, in effect, write it down on that single most important document they confront during the course of a calendar year, their tax returns. That is a message you cannot ignore, and I think they would be energized to provide you that message if they really thought, as attested to by a balanced budget amendment, that you guys meant it; that you were serious about it.

Mr. HERGER. Thank you again for your testimony.

Mr. Kleczka will inquire.

Mr. KLECZKA. Thank you, Mr. Chairman.

I do not know if you gentlemen were here for my opening statement on this issue this morning, but I might indicate that I have my misgivings about it. There were those in years past who called it irresponsible. I would go as far as calling it misguided.

I see that in the Walker testimony that the program has been changed somewhat, wherein if in fact Congress were to pass a reconciliation bill of $50 billion, the deficit checkoff would total $40 billion, at that point no action would need to be taken.

I am saying at that point, if that is the new change in the legislation we will be considering, then you have really made it a sham. Because all those folks who checked the box thinking this was really going to do something above and beyond what has already been done, have just been not lied to but have not been honest with, OK?

So, now maybe I have to amend my remarks by saying it is misguided and now it is going to the point of being phony also.

But if in fact we want to give taxpayers of this country the right to help us budget on form 1040, my idea this morning, and it is still a high priority of mine, would be to give them two options.

Number one, one box for deficit reduction. If in fact you check that box, we will provide a series of boxes in the next column with broad categories of Federal spending, like defense, like welfare, like veterans benefits. And let us ask those same taxpayers to further help Congress out and check one or more of the other boxes. Because what will happen is, once we add this option, if this ever goes through, God forbid, we are going to be faced with not only all the cuts we have to activate because of the tax cuts that are coming before this committee, but other portions of the Contract will have more spending cuts. The balanced budget will entail more spending cuts, and at that point I think there comes a time where if we are to be told in one year, late in that year, that you need to do another $50 billion, we will have serious problems around here.

So I am saying let us ask the taxpayers to identify their least-liked program and have another column and check a box there.

Would you gentlemen support that amendment?

Mr. TURE. No, sir, I would not. In my testimony, the full statement, you will find that I have a discussion of that very point. And let me see if I can very briefly——

Mr. KLECZKA. I do have 5 minutes and I want the other panelists to also respond.

Mr. TURE. I will very briefly address it. I think you will have a great deal of difficulty selecting at random any 100 taxpayers and ask them to identify 5 explicit line items in the budget.

Mr. KLECZKA. I said broad categories.

Mr. TURE. Broad categories.

Mr. KLECZKA. Defense, welfare.

Mr. TURE. No, I think that is an unfair demand to make of the taxpayer. Taxpayers know or have a feeling that they are being asked to finance too much government. I think you have gotten that message very loudly and clearly last November. If you ask them specific programs or even specific categories of programs——

Mr. KLECZKA. Broad, not specific. Broad.

Mr. TURE. Broad programs. I think you are asking them to do something they are not capable of doing.

Mr. KLECZKA. Would the other gentlemen like to respond also?

Mr. SCHATZ. We did a survey of our members in December, and I can assure you that there is very little they would wish to exempt, other than Social Security, which I think really addresses everything that everyone has been saying here. Everything should be on the table.

Mr. KLECZKA. Including defense?

Mr. SCHATZ. Including defense.

Mr. KLECZKA. So your group is not too enamored with us increasing defense spending?

Mr. SCHATZ. I did not say that. I think there is plenty of room to make cuts in defense. I think everyone has agreed, including the President, that there is a need to increase spending on defense. But there are reductions, there is still procurement reform and management changes you can make. You can do a lot of things without affecting readiness, which, again, I think everybody agrees upon.

Mr. MERSKI. I think I would have a problem of asking taxpayers to do Congress' job of identifying where the waste, fraud and abuse and spending could be cut. I do not think anyone is losing any sleep at night that spending would be cut too fast or too much.

What I would say is that identifying broad categories of spending cuts is part of the political process up here right now, and I do not see putting a broad category on a tax return helping that effort in any significant way. And, in fact, the legislation has an across-the-board sequester if the spending cuts are not made. So it would cover all programs if cuts were not identified by policymakers who are supposed to be making those cuts in the first place.

Mr. KLECZKA. Let me, in closing, cite an article that was in The Hill, a newspaper that circulates around here. It indicates that Jim Kolbe and another Member, Joe Knollenberg, introduced a welfare proposal today that would allow citizens to direct up to 10 percent of their income tax bill to private charity.

So now we have the taxpayers checking off 10 percent for deficit reduction, here is another 10 percent for charity. I am assuming there will be some other ideas. We will get to the point where all 100 percent is already earmarked, and at that point you do not need the Congress: Government will have to run without it.

So this proposal, I restate, is misguided, and I know full well it will be followed by others, like the Kolbe proposal, where they have a pet program and they want 10 percent of the pie, and all of a sudden, my friends, we will run out of the pie.

Thank you.

Mr. HERGER. Thank you, Mr. Kleczka.

The gentleman from Missouri, Mr. Hancock.

Mr. HANCOCK. Thank you very much.

I would like to say to this particular panel that I hope you will continue to send me the reports and the information that you periodically send out. I have used it extensively over the last 6 years that I have been in the Congress and before. In fact, I supported your organizations before I came into the Congress.

I would like to make just this one comment. After what has gone on here just in the past couple of days, I have a little reservation about a public debt reduction trust fund, after I see what has happened over there in the White House having to do with the Currency Stabilization Trust Fund. I might just throw that out for you to think about.

Thank you.

Mr. HERGER. Thank you.

The gentleman from Maryland, Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Let me thank our three panelists for their testimony here. I agree that we need to take responsible action to reduce the Federal deficit, and I would suggest that perhaps the most important thing we could do is to make sure we do the spending cuts that are necessary to get us on the glidepath to reduce the Federal deficit, before we take up the tax cut bill that is before this committee.

The tax cut bill would reduce revenues by $720 billion, according to Treasury. Congress has never been able to cut that much out of spending. It is interesting that we do not have any specific proposals to reduce spending by the leadership, but we do have a specific proposal to reduce revenues.

So I would hope, if we are at all serious about deficit reduction, we will start talking about slowing down the tax cut bill until we know we have the revenues in order to pay for it and continue deficit reduction.

And I would assume that my colleagues would agree with that, and the witnesses, who are serious about deficit reduction, will be equally articulate about making sure the tax bill is paid for and we are on deficit reduction.

I think Mr. Walker is correct in trying to find a way to get the average person involved in deficit reduction, and I thank Mr. Walker for being here today and staying through the hearing and presenting a proposal. I am glad to see that there have been changes made in his proposal. I think those changes were needed. I think additional changes are still needed.

One thing that I would urge is that we do not put this proposal on a fast track. Let us work together, as Democrats and Republicans, and see if we cannot find a way to get the taxpayer involved in deficit reduction without any unintended consequences, which I think this legislation still would have.

I am still not clear as to whether the checkoff is 1 year or cumulative. At least in one version of the bill there was a cumulative checkoff, so that if in one year you had $10 billion, that became the base for year two; then in year two if you had another $10 billion, it became $20 billion for that year. And I assume eventually 100 percent of our tax collections would go for deficit reduction if you followed that logic. And I assume that was not the intent of the sponsors, but I want to be sure we do not have unintended consequences.

I would also suggest that, as presently constituted, I am not sure we will accomplish the objective that you have brought out in your testimony. I am not sure the public will have confidence that it is participating in deficit reduction if their action in year one does not really become reality for a couple years later.

If I understand, it would be 1994 taxes that would actually go to reduce deficits in 1997. And that seems a little bit far removed for us to be able to make a case to our taxpayers that, in fact, they are directly participating in deficit reduction.

I am also concerned by the perception that will be out there that you may be voting for deficit reduction, but if reconciliation—which my taxpayers have absolutely no knowledge at all of what reconciliation means—is higher, then your vote for deficit reduction has no impact. They are not going to understand that. They will not understand what that means. I also think we will lose a little bit of credibility there.

And I would point out, and I appreciate the response that has already been made on the class issue, that only people who have large tax liabilities have a chance to vote here. But, remember, we are not talking about dollar-for-dollar reduction. If I understand it, we are talking about the potential for some across-the-board reduction in Federal spending, which is a policy decision being made by people who have more wealth than people who do not have wealth, because they do not have a chance to vote. That is a policy determination. And we are doing that by dollars.

So I guess my question—and you only have 10 seconds to respond, unfortunately—is that understanding this is not going to be today's dollars paying off today's debt, but today's dollars paying off tomorrow's debt, and that the unpredictability of whether it will mean anything at all, whether we will gain any credibility with the public at all with this proposal, that they are in fact participating in deficit reduction.

Mr. SCHATZ. I would just say very quickly that it is a little bit, maybe, like a savings account. People are giving money now, and if you explain to them what the situation is, I think they would be perfectly willing to do that. I know I would. Maybe because we are so involved as an organization in this, and I am sure many of our members would.

Say a contribution from an individual that comes into this organization may or may not get spent in the same year, but the fact is that they are looking at getting rid of the debt. And if it takes 2, 3, 4, or 5 years, they know it is being set aside for that purpose. That is critical.

Mr. CARDIN. Of course, you know people can add to their tax liability today and pay off the debt, and very few people do. We will take a check from you right now to help pay off the debt.

Mr. SCHATZ. I am afraid I don't have $17,000. I am sorry.

Mr. HERGER. Let's see, Mr. Christensen does not have any questions.

Anyone else for any followup?

I thank our panelists. It has been very helpful. And with that, this Committee of Ways and Means will stand adjourned.

Thank you.

[Whereupon, at 2:55 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the
American Automobile Manufacturers Association
Submitted for the Record

Committee on Ways and Means
U.S. House of Representatives

Hearings on H.R. 9
The Job Creation and Wage Enhancement Bill of 1995

The American Automobile Manufacturers Association (AAMA) appreciates the opportunity to submit this statement for the record on section 12002 of H.R. 9, a provision that has important economic implications for countless small firms that purchase motor vehicles for use in their businesses, as well as for the domestic automobile industry. The issue is first-year expensing, which is currently available for all business assets except motor vehicles. It is proposed in H.R. 9 that the current expensing limit be raised from $17,500 to $25,000.

AAMA is the trade association for the domestic automobile manufacturing industry. Our members are Chrysler Corporation, Ford Motor Company, and General Motors Corporation. Together, our members employ more than 600,000 workers directly and account for another 1,500,000 jobs through their dealers and suppliers.

Internal Revenue Code section 179 allows small businesses to expense up to $17,500 of the cost of most depreciable assets. However, section 280F of the Code limits to $3,060 the amount a small business can deduct for a business-use passenger car or light-duty truck in the first year through either depreciation or expensing. Thus, small businesses that purchase a car or light-duty truck during a year are unfairly denied the benefits of section 179. The proposal to raise the section 179 limit to $25,000 would not alleviate this disparity. AAMA urges extending the applicability of Code section 179 to purchases of business-use automobiles and light-duty trucks by amending the cap imposed by section 280F of the Code.

The businesses directly affected by this limitation are those small businesses whose only asset purchase for a tax year is a motor vehicle. They are the truly small businesses in America -- the local carpenters, plumbers, grocers, florists -- businesses so small that they often are not well represented before Congress. If the only significant asset purchased by such a business in a year is a motor vehicle, the business receives no benefit from section 179 expensing. This increases the after-tax cost of the purchase of a motor vehicle relative to other business assets.

For example, a business asset costing $20,000 and not subject to the section 280F limits would be allowed $17,500 first-year expensing under section 179, plus full first-year depreciation on the remaining cost of $2,500. In contrast, a business-use motor vehicle costing $20,000 would be limited to first-year depreciation of $3,060 with no section 179 expensing. Thus, section 280F not only limits ordinary depreciation deductions for so-called "luxury" vehicles", but also effectively disallows section 179 expensing of the "non-luxury" cost (i.e. $15,300, the amount of non-luxury depreciation allowable under section 280F over a vehicle's five year recovery period). No other business asset is subject to a so-called "luxury" cap. Moreover, to call $15,300 a "luxury" cap is a misnomer.

The current rules, thus, discriminate against small firms who invest in business-use vehicles as compared to small firms who make non-automotive investments. A simple and more equitable solution would be to allow for expensing of motor vehicles, at least up to the five year "luxury" depreciation limit, currently $15,300. This would reduce the discrimination against the small firms that invest only in business-use vehicles during a tax year, without changing the "luxury" depreciation limits. In other words, small businesses purchasing cars or light-duty trucks should be allowed to benefit from enhanced expensing rules, at least to the extent of the "non-luxury" content of the purchased vehicles. This would place all small businesses on a more equitable footing, whether they invest in motor vehicles or in non-automotive business assets. We believe such improved neutrality is essential to effective, efficient and equitable tax law.

Whether or not a motor vehicle qualifies for additional first-year expensing has important cash flow implications for small firms. This is because qualifying for expense treatment would lower the present value of a vehicle's after-tax purchase cost by varying amounts, depending on the price of the vehicle and the purchaser's marginal tax rate. For example, the after-tax cost of a vehicle costing $20,000 could be reduced by more than 7% (assuming a 35% marginal tax rate for the purchaser).

The purchasers of motor vehicles, especially small businesses, are very responsive to price changes. It is estimated that a 7% price decrease could bring about a 7% increase in vehicle purchases by affected small businesses. Thus, current law not only adversely impacts the cash flow of small businesses, it is also harmful to the interests of the automobile industry. The lower sales level resulting from this discriminatory provision costs automobile industry jobs. Industry economists estimate allowing additional first-year expensing for motor vehicles could increase industry sales by 15,000 to 20,000 units per year, supporting an additional 2,500 to 3,500 jobs in auto and auto related industries.

The limitation on small business expensing is only one of a number of provisions in the Code that discriminate against purchasers of automobiles. The so-called "luxury" depreciation cap cited above is an example, as is the five year class life, when three years more appropriately reflects economic life for business-use automobiles according to a 1991 Treasury study. We hope that Congress will address these inequities in the future, but, above all, we hope future legislation does not exacerbate the existing discrimination. It should be noted that, as drafted, the proposal to increase the section 179 expensing limit, as well as the Neutral Cost Recovery proposal, would improve cost recovery rules for business assets generally, but would not benefit businesses that purchase motor vehicles. Thus, Congress is currently considering proposals that would worsen the cost recovery rules for motor vehicles relative to other business assets. We respectively request that any bills reported out of the Committee treat purchasers of business-use motor vehicles equitably vis-a-vis purchasers of other business assets.

In summary, AAMA urges the Committee to allow purchasers of business-use passenger cars and light-duty trucks the benefits of the section 179 additional first-year expensing, at least up to the luxury depreciation cap of section 280F. In testimony before the House Committee on Small Business, January 17, 1995, The Small Business Survival Committee and the National Association of Manufacturers both supported making section 179 expensing available to purchasers of motor vehicles.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association ("ABA") appreciates the opportunity to comment on the tax provisions contained within the "Contract with America" which were, among other things, designed to encourage people to enhance their financial security by increasing their savings and investment. Another way for hundreds of thousands of small business owners and farmers to enhance their financial security is by assuring them that the businesses and farms that they have worked so hard to sustain can be passed down intact to other family members when the business owner or farmer dies.

The tax provisions of the "Contract with America" which are contained in H.R. 9 that was introduced by Chairman Bill Archer on January 9, includes several important small business incentives. The one that the American Bankers Association ("ABA") would like to address is the provision that would phase in an increase in the estate and gift tax exemption from $600,000 to $750,000.

The federal government's system of transfer taxation imposes a combined tax on the value of estates at death, gifts during life, and generation-skipping transfers. It was the Revenue Act of 1916 that began the process of estate taxes becoming a permanent source of federal revenue. The gross value of a decedent's estate at the time of death was determined and a number of allowable deductions were made to arrive at the net value of the estate. A general exemption was taken and the amount of tax due was then calculated using a schedule of progressive rates. The 1916 Act granted a $50,000 exemption to exclude relatively small estates from taxation.

Over the years the estate and gift tax systems ebbed and flowed as the United States engaged in two World Wars, struggled during the Great Depression and experienced a surge of economic prosperity. It was not until the Tax Reform Act of 1976 that a complete overhaul of the transfer taxation system occurred which unified portions of the separate estate and gift tax systems.

In 1976 the separate estate and gift tax exemptions were replaced with a single unified tax credit. Over the five year period from 1977 to 1981, legislative provisions gradually increased the value of this credit from $30,000 to $47,500, which are equal in value to exemptions of $120,667 and $175,625, respectively.

One of the concerns that had been raised in regards to the transfer tax system is the effect the taxes had on small business and farm activity. Upon the death of the proprietor of the business or farm, the assets of the business become subject to estate taxation. Such taxation creates a heavy financial burden at a sensitive and critical time which may compel these small and even medium-sized businesses and farms to close their doors and sell off the farm or business even though these enterprises would otherwise be productive and profitable.

The 1976 Act attempted to mitigate these problems by providing favorable valuation rules for small businesses and farms and by deferring the payment of taxes on estates composed largely of such small businesses and farms.

The Economic Recovery Tax Act of 1981 built on many of the provisions of the 1976 legislation by raising the unified credit and by providing additional relief to small businesses and farms. The Joint Committee gave the following as the reason for the changes:

> Inflation has been increasing the estate and gift tax burdens by eroding the value of the credit and pushing estates and gifts into higher transfer tax brackets. In addition, the Congress determined that the amount of the prior credit, established in 1976 and fully effective in 1981, was inadequate to provide relief for estates containing farms, ranches, and small businesses which often were forced to dispose of family businesses to pay the estate or gift tax.

The 1981 Act gradually increased the amount of the unified credit from $47,000 to the now current amount of $192,800 over a six-year period. With the unified credit at $192,800 there will be no estate or gift tax payment on transfers of property which total $600,000 or less. The 1981 Act not only continued the liberal rules relating to small businesses and farms in connection with valuation and extension of time for payment but made it easier for businesses and farms to qualify.

The increase in the unified credit that was contained in the "Contract with America" and in H.R. 9 will go a long way towards continuing the protection of small businesses and farms that have been the special concern of Congress for many years. Section 12001 of H.R. 9 increases the unified estate and gift tax credit from $600,000 to $750,000 in 1998 with a cost of living adjustment for decedents dying and gifts made in a calendar year after 1998.

The very nature of entrepreneurial activity results in the accumulation of a certain amount of wealth. During his or her working life, the proprietor of a relatively small manufacturing operation or family farm may accumulate millions of dollars worth of land, plant and equipment. It is a valid goal of Congress to continue to protect these enterprises as family owned businesses generate about 60 percent of our gross domestic product. During the 1980s, family owned businesses accounted for an increase of more than 20 million private sector jobs.

The ABA supports the increase in the unified credit as it will help our many customers by allowing them the opportunity to continue to operate their businesses and farms. Continuation of these enterprises will provide job security for employees. Unexpected unemployment can cause tremendous disruption in people's lives; providing job security should be one of Congress' highest priorities. It will reduce the burden to the Internal Revenue Service as the Service will no longer need to process as many estate tax returns. Many of these returns do not generate revenue to the federal government due to the many credits (such as the unified credit) that an estate may claim against estate tax owed. It would not be an undue assumption that the costs of administering the returns of these small estates may not be justified in light of the fact that these small estate generate little tax. The fewer returns that have to be processed the lower the costs to the Service.

In addition to all the benefits, such a change in the unified credit will not cause a huge decrease in federal revenue. Increasing the unified credit would actually have a minimal effect on total revenue. The amount of revenue generated from estates between $600,000 and $1 million represents only 5% of the total revenue received from estate and gift taxes and totals only .03% of total revenues of the federal government.

Change In Income Tax Rates for Trusts and Estates

While supporting the increase in the unified credit, the ABA feels that there is another area which will provide protection to not only individual farmers and businessmen but also thousands of other middle class Americans.

How can Congress simplify the tax laws, empower people to establish vehicles that will provide for family members who may have medical or other challenges, empower people to establish vehicles that will pay for the educational of grandchildren and other family members, and last, but not least, correct an inequity in the tax system that has existed since 1986?

Congress can do all this by changing the income tax rates for trusts and estates. The Revenue Reconciliation Act of 1993 exacerbated an inequitable practice that started with the Tax Reform Act of 1986. What happened in 1993 is that the income tax rates for estates and trusts were again increased and even more importantly the tax brackets were again sharply compressed.

The result is that funds which are income for an estate or trust are subject to more tax than if those same funds were passed through the trust or estate and were in the hands of individuals who would also have to pay income tax on these same funds. It is only the fact that these monies are income for an estate or trust rather than an individual which subjects them to a much higher rate of tax.

Unlike the starting point of $19,500 for taxing income under the married filing separately category (which bears the highest tax rates applicable to individual taxpayers), trust and estates must begin to pay tax on their income at just $1,550. The highest rate of tax at 36% affects individuals who are married filing separately who have income over $71,800. The same high rate of tax of 36% applies to estates and trusts that have income over $5,600.

It has not always been this way. Before the enactment of the Tax Reform Act of 1986, estates and trusts were taxed at the married filing separately rates.

The trust department of banks are concerned about this issue because it affects our many bank clients who utilize trust services offered by the bank to carry out their wishes in regards to how they want their estate or their assets which are held in trust to be handled. These bank clients are certainly not multi-millionaires but their assets are held in trust for long range planning of the families' needs and many just want the assets that they have accumulated over their lifetimes to go to whomever they choose at their death rather than whom their wives may choose. A recent article that appeared in the January 9, 1996 edition of the Wall Street Journal entitled "Trust Funds Are Just for the Rich? Think Again" stated that:

> Once the province of the very rich, trusts have found their way into the lives of many families who never thought of themselves as wealthy. The escalation in housing prices since the 1970s and the boom in the stock and bond markets during the 1980s and early 1990s have helped push more estates above the federal estate-tax exemption (which is currently $600,000). At the same time, longer life spans, second marriages and lawsuits have more people looking for ways to protect and to manage family assets.

In a more recent article dated January 29, 1995 an article in the Washington Post entitled "QTIP Trusts Help Clean Up Many Estate Planning Messes" stated that:

> Today, the interaction of economic and social change has complicated things immensely, and thousands of families each year confront the vexing question of how to see that a surviving spouse, usually a wife, is provided for while making sure that the husband's assets go to the children after the widow's death.

There are indeed many reasons to set up trusts such as the QTIP trust for estate planning purposes. The Washington Post article continues its estate planning analysis by stating:

> Trusts are the vehicles of choice both to defer estate taxes until the surviving spouse dies and also to guarantee, especially in the context of second marriages, that your assets will be transferred to the beneficiaries of your choice rather than to your second spouse's choice.

There is nothing sinister about trusts or estates that should subject them to such onerous tax burdens. This is especially true for an estate which automatically comes into existence upon the death of a decedent. It contains the property of the person who has died. An executor is appointed who collects income that the decedent was entitled to, pays expenses and makes disbursements. The taxable income of an estate is taxed to the estate unless it is distributed to beneficiaries before the end of the estate's tax year.

There are many non-tax reasons for accumulation in estates and trusts. For example, estates may accumulate income because of the liquidity needs to pay bequests and debts (including taxes); unavoidable recognition of income (IRA and other qualified plan distributions); state law requirements that distributions cannot be made until the claims period for debts expires (personal liability of executor); litigation; and will contests, etc. Trusts may need to build up the trust assets to establish a fund for the future education of minor children, for the care of surviving spouses, orphans, elderly parents, the mentally or physically disabled, or children with special needs. A trustee may make a choice not to distribute assets in certain situations, not for the accumulation of assets, but to protect beneficiaries in certain situations, such as problems with creditors or a beneficiary who is a drug addict.

Is it possible to use these vehicles to avoid the payment of income taxes? Anything is possible, however, an individual does not go to the extreme of dying simply to use an estate as a vehicle to avoid the payment of income tax. There is also nothing sinister or subversive about the use of a trust. A trust is a commonly used estate planning vehicle that allows individuals to provide for their families' needs and/or to achieve certain goals while those individuals are alive or after they have passed away. For example, trusts are set up to save for college or to provide a living allowance for people with disabilities or mental illnesses.

The highly compressed rates which were part of the 1993 Act have had a harsh effect on many trusts and estates. The greatest areas of difficulty arise in instances where there is a need to accumulate income for non-tax reasons. The grantors intentions for the best interests of the beneficiaries are frustrated by the trustees' unenviable position of having to choose to use the assets of the trust or estate to either pay the tax (at a much higher rate than would be taxed in the hands of the individual receiving it) or make unwise distributions to avoid the additional tax.

Let's go over the current rate structure again. Unlike the starting point of $19,500 for taxing income under the married filing separately category (which bears the highest tax rates applicable to individual taxpayers), trust and estates must begin to pay tax on their income at just $1,550. The highest rate of tax at 36% affects individuals who are married filing separately who have income over $71,800. The same high rate of tax of 36% applies to estates and trusts that have income over $5,600.

There was a period of time, a long time ago, when the income tax rates for individuals were higher than those of trusts or estates and therefore there was an incentive for people to set up "multiple trusts" in order to avoid the payment of income taxes. In the unlikely scenario that sometime in the future the individual income tax rate at the highest level will be higher than the top estate and trust income tax rate level, Congress has given the IRS the necessary weapons to combat this "multiple trust evil" by the ability to issue regulations which would treat as one trust, two or more trusts having substantially the same person establishing the trusts and the same beneficiaries, where the principal purpose of the establishment of such trusts was the avoidance of tax. With this device already established in the tax code, an individual cannot hold money inside a trust or estate to enjoy lower income tax rates.

How to Make the Needed Changes

Several members of Congress have already been compelled to try to change this inequitable situation by introducing legislation in both the 103rd Congress and also in these early days of the 104th Congress.

S. 1729 was introduced by Pete Domenici on November 19, 1993. The bill would have established a special income tax rate for disability and higher education trusts.

H.R. 5070 was introduced on September 21, 1994 by L.F. Payne (D-Virginia). The bill would have established a special income tax rate for disability trusts.

H.R. 5169 was introduced on October 4, 1994 by Jim McCrery (R-LA). The bill would have changed the income tax rate on estates and trusts back to the married filing separately rate. Again, the married filing separately rate bears the highest tax rates applicable to individual taxpayers.

The McCrery bill was re-introduced in the 104th session of Congress as H.R. 329 on January 4, 1995. The bill, which is supported by the American Bankers Association would change the income tax rates on estates and trusts back to the married filing separately rate.

Conclusion

The McCrery bill presents the best solution to this inequitable situation. It simplifies the Internal Revenue Code by including estates and trusts in the married filing separately tax brackets. This eliminates one rate table. It will more importantly, help to provide protection to middle class Americans at their death to continue their wishes in regards to supporting their children and other family members through estates or trusts without confiscatory income tax rates eating away at assets which took a lifetime for those middle class Americans to collect. There is no "evil" that trusts or estates represent which should make them the subject of such high rates and compressed brackets. Congress can make sure that individuals can never use these trusts or estates to avoid the payment of income taxes by putting income tax rates for trusts and estates at the highest level an individual's income tax rate could be.

STATEMENT OF LYNNE Z. GOLD-BIKEN AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Committee:

I am Lynne Z. Gold-Bikin of Norristown, Pennsylvania. During my career as a lawyer, my practice has been limited to family law. I am presently Chair of the Section of Family Law of the American Bar Association. I am submitting this statement on behalf of the American Bar Association, as the designee of its President, George E. Bushnell, Jr.

The ABA strongly supports enactment of a tax credit for qualified adoption expenses, such as that found in the Family Reinforcement Act, H.R. 11. We believe its enactment is important for several reasons. First, it will encourage more families to adopt children, by reducing the financial burden of one-time costs which are currently estimated to average $10,000. Second, adoption incentives are less costly to society than institutional alternatives. By making adoption more affordable for thousands of families, fewer children will stay in more costly institutional settings. Most importantly, encouraging adoption is important because adoption is the vastly preferable outcome for adoption-eligible children, providing permanency and a loving environment for children who otherwise may languish in foster care, shelter care or group-care settings. We urge the Committee to support this provision as this much-needed legislation moves forward.

In addition, we urge the Committee to consider the additional step of exempting from taxation employee adoption assistance benefits provided by employers.

The American Bar Association has long supported improvements in the law related to the adoption of children. In 1972 it endorsed a Revised Uniform Adoption Act. In 1980, it endorsed reforms in the federal Adoption Assistance and Child Welfare Act of 1980 (P.L. 96-272) to facilitate adoption of children with special needs. Currently, Association representatives are working with the National Conference of Commissioners on Uniform state Laws on the development of a new version of the Uniform Adoption Act. Most recently, in February 1993, the ABA House of Delegates approved a Family Law Section-sponsored resolution calling for the federal government and Congress to take a number of further steps to encourage adoption. This most recent resolution forms the basis for this testimony. A copy of the resolution is attached.

In all of its work on adoption, the ABA, primarily through its Family Law Section's Adoption Committee and the ABA Center on Children and the Law of the Young Lawyers Division, has been concerned about legislative improvements designed to build and nurture strong families, including legislation to encourage families to adopt children in need of a nurturing environment. Leaders within the ABA involved with adoption issues have worked with such organizations as the North American Council on Adoptable Children, the National Adoption Information Clearinghouse, the National Resource Center for the Adoption of Children with Special Needs, Adoptive Families of America, and the American Academy of Adoption Attorneys to identify needed enhancements in adoption laws.

The ABA believes that, in establishing public policy to encourage people to adopt children, the federal government (and its state counterparts) must enact policies which will help compensate adoptive parents for the extraordinary costs which are required in the process. While the single largest cost of "newborn" adoption is generally medical expenses of prenatal care and delivery as well as care of the baby, there are a myriad of costs in any given adoptive placement. These include counselling, agency fees, living expenses of the birth mother during pregnancy, health care costs of the child pending adoption, legal fees, and a variety of court costs and document charges in one or more states or countries.

In addition, travel expenses are often unpredictable and cannot be preplanned. Where extended travel is required, there are hidden costs such as lost earnings or child care for other members of the family. It must be noted that in many instances all of these costs are incurred for potential adoptive placements which do not materialize.

Apart from the direct costs, these situations in some instances entail a need for counselling or therapy for the child and even for the entire family. From time to time, unexpected medical conditions will be uninsurable.

If a child's physical or mental health problems are known at the time of the adoption, a child may qualify as having "special needs" under applicable state laws and policies, and the adoptive parents may be able to obtain financial support to meet these needs through an existing government entitlement program. However, not all such problems are known at the time of an adoptive placement, and not all conditions which require special care fall within the varied standards for the "special needs" designation. Therefore, adopting parents assume a substantial risk of significant unanticipated expenses when adopting older children (i.e., those no longer in the "newborn" category).

The 1993 ABA policy resolution on adoption is based on a recognition by those who practice family law, particularly with a specialization in adoption, as well as by those who have adopted children, that the expense incurred in connection with an adoption can be phenomenal. Our position is also based on the recognition that federal law has failed to provide reasonable financial incentives that would help offset these costs for low and middle-income households.

The ABA recognizes the importance of public policy that specially promotes the adoption of "special needs" children with disabilities; older children in the foster care system; children with special health problems (e.g., drug-exposed babies and children with HIV or AIDS); and children who are otherwise designated by public child welfare agencies as difficult to adopt.

In addition, we support enactment of legislation to provide incentives to employers who provide special employee assistance benefits specifically related to adoption. There are now only a small number of employers that provide such benefits, even though employee assistance benefit programs generally have expanded considerably in recent years. Small employers might only be able to provide very limited assistance in the adoption area (such as limited counselling, legal information for those considering adopting, and assistance with some legal expenses), while large employers may -- with appropriate tax incentives -- be able to provide a much wider array of employee benefits related to adoption.

The federal government itself is a large employer, and federal agencies can develop models of employee assistance related to adoption. Large numbers of federal workers in the U.S. and throughout the world (including members of the military services) are potential adoptive parents. Pilot or demonstration projects focusing on a variety of employee assistance in adoption can furnish state governments and private employers with much useful information about how to structure and operate a successful employee adoption assistance program.

RESOLUTION APPROVED BY
HOUSE OF DELEGATES OF THE
AMERICAN BAR ASSOCIATION

FEBRUARY 1993

RESOLVED, that the American Bar Association urges the United States Congress to enact legislation providing incentives to encourage individuals throughout the country to adopt juveniles. Such incentives should include:

(a) The allowance of reasonable tax deductions or tax credits for qualified adoption expenses incurred for the adoption of juveniles designated by state or local child welfare agencies as having "special needs."

(b) The provision of tax incentives for employers that provide employees with adoption assistance benefits.

(c) The creation of Federal agency demonstration projects in which federal employees are provided with an adoption assistance benefit program.

(d) The creation of a Federal interagency work group on adoption.

(e) The establishment of a Federal "blue-ribbon" advisory board on adoption.

(f) The provision of Federal support for the development of activities designed to increase understanding of adoption and its impact.

(g) The enactment of Federal legislation or regulations that encourage full disclosure to prospective adoptive parents of information related to the physical and mental health history of all children being placed for adoption, and the inclusion in any new Federal health care legislation of provisions that prevent the denial of dependent coverage to adoptive parents on the basis that the adopted child has a health condition that was pre-existing the date of the adoption.

AMERICAN COUNCIL ON EDUCATION
Office of Vice President and General Counsel

February 2, 1995

The Honorable William Archer
Chairman
House Committee on Ways & Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the higher education associations listed below, we wish to express our support for the establishment of American Dream Savings Account (ADS Account), and other pending proposals which would expand the concept of Individual Retirement Accounts.

In view of the significant decline in personal savings and resulting detrimental impact on trade and international competitiveness, we welcome the initiative to encourage saving not only for retirement, but also for either the purchase of a first home or paying for the costs of college.

By enabling penalty-free withdrawal of ADS funds, parents have an additional resource to call upon in meeting the cost of their children's education. In addition, students of all ages as well as spouses and grandparents will be able to significantly participate in saving for anticipated education expenses.

We further support the concept incorporated in HR 682, the Super IRA bill. In particular, we appreciate the understanding that colleges, universities, independent schools and research organizations rely upon Section 403(b) of the Internal Revenue Code to provide both their primary employer-sponsored pension plans and an opportunity for their employees to voluntarily save for retirement with their own pre-tax dollars. The extension of penalty-free withdrawal treatment to distributions of voluntary employee 403(b) contributions for the purchase of a home or for higher education expenses is a potentially valuable benefit for the higher education community.

HR 682 would also stop the unfairness that results when a 10 percent penalty is charged because health costs require IRA funds to be withdrawn. The bill addresses another case of unfairness when taxpayers lose their jobs, and have to unexpectedly fall back on their IRA savings. For taxpayers who have exhausted 12 weeks or more of unemployment compensation, they will be allowed to make a penalty-free withdrawal as well.

Lastly, the bill addresses an issue relating to families that are trying to make a better future for themselves by enabling families to save for their education without violating the AFDC eligibility rules.

We hope that this initiative would be supplemental to and not in lieu of extension of full employee educational benefits under Section 127 of the Internal Revenue Code and other provisions that would expand educational opportunity in our country.

We stand ready to aid you and your staff in pursuit of this valuable proposal.

Sincerely,

Sheldon Elliot Steinbach

Sheldon Elliot Steinbach
Vice President & General Counsel

SES:ggl

cc: Jim Clark, Chief Tax Counsel, House Ways & Means Committee
Sam Gibbons, Ranking Minority Member, House Ways & Means Committee
Phil Moseley, Chief of Staff, House Ways & Means Committee

On behalf of the following associations:
American Council on Education
American Association of Community Colleges
American Association of State Colleges and Universities
Association of Community College Trustees
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
College University Personnel Association
Council of Graduate Schools
Council of Independent Colleges
Hispanic Association of Colleges and Universities
National Association for Equal Opportunity in Higher Education
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Student Financial Aid Administrators
National Association of State Universities and Land-Grant Colleges
Teacher's Insurance Annuity Association - College Retirement Equity Fund
United Negro College Fund

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE HOUSE WAYS AND MEANS COMMITTEE ON ESTATE TAXES

FEBRUARY 1, 1995

The American Farm Bureau Federation is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Policy is developed by producer members at the county, state and national levels of organization.

Farm Bureau applauds the efforts of this committee to hold hearings focusing on changes needed in estate tax law. Reform of our nation's estate taxes has been at the top of Farm Bureau's agenda for many years.

Farmers and ranchers have a vital interest in estate taxes because production agriculture remains a family enterprise based industry. According to the 1992 Census of Agriculture, 85.9 percent of the farms and ranches are individual or family proprietorships and 9.7 percent are partnerships. Of the 3.4 percent that are family corporations, most have 10 stockholders or less. Only 0.4 percent of the farms and ranches are corporations that are not family held. Farms and ranches that have incorporated have done so for tax and financial planning reasons, not because they are large business enterprises.

While some farms and ranches stay in the family for generations, the actual operators of farm and ranch enterprises are constantly changing. The U.S. Department of Agriculture estimates that between 1992 and 2002 about 500,000 older farmers will leave production agriculture to be replaced by about 250,000 new, young farmers. This is partly happening because the average age of farmers in 1992, according to the census, was 53.3 years. For these retiring farmers and ranchers and the new ones who would like to take their place, now is an important time to make changes in the federal estate tax laws.

Without estate tax law changes the next generation of farmers will find it more difficult to begin farming. According to a USDA analysis of census data collected in 1988, roughly 45 percent of the young farmers who had obtained land had either purchased it from a relative (29 percent) or had received it as an inheritance or gift (15 percent). What those numbers would be without estate taxes and capital gains taxes, we will never know. What we do know is that multi-generation farms and ranches are a fact of life. How viable they will remain will be partly determined by the estate tax load they must carry.

Even though land prices declined in many areas of the country during the 1980's, in both real and nominal terms, they have recovered in recent years in most areas. As a result many farmers and ranchers are facing far higher land prices today than when they purchased the land 30 or 40 years ago. Much of this gain is due to nothing more than inflation. For example, the average price of farmland in Illinois was $234 per acre in 1965; now it is close to $1,500 per acre, over six times what it was in 1965. All portions of the country face the same problems.

Farm Bureau has advocated for many years that the estate tax be abolished. Elimination of the estate tax should not be a major budget issue. Last year, total estate and gift tax revenue came to about $13 billion. While $13 billion is still a considerable amount of money even by today's standards, it is not such a large amount to prevent its phase-out over a number of years.

The unified credit which effectively exempts from taxes the first $600,000 of value of an estate was last increased in 1981. Due to gradual inflation and pressure from land development, the current $192,800 unified tax credit and allowance for farm use valuation are not sufficient to allow many family farm businesses to pass from one generation to the next.

Farm Bureau supports increasing the estate tax exemption from $600,000 to $2 million and indexing the exemption for inflation. Exact numbers are not available, but this level would likely exempt many farms and ranches from estate taxes and allow them to be passed from one generation to another, unencumbered by federal taxes. If the exemption is not increased and a large portion of farm business assets must be sold to pay the tax, the economic viability of the operation can be destroyed and family members would be forced to abandon the farm.

The impact of an increase in the exemption to $2 million would be significant. For example, the current exemption would exclude 400 acres of average priced Illinois farmland from the estate tax. Again using Illinois as an example, family farms are now more than 400 acres and at least half the land is valued at more than $1,500 per acre. This means the total value of the farming enterprise would be more than $600,000 when the value of equipment, livestock and other assets are considered. Increasing the exemption would allow many farms to be passed tax-free to the next generation of farmers.

Another estate tax issue of importance to farmers and ranchers is the $750,000 ceiling allowed under Internal Revenue Code 2032A for valuing land at its agricultural productive value. Farm Bureau supports elimination of the $750,000 limit to the adjustment in value that can be made when farmland is valued at its actual use rather than its highest and best use under Section 2032A.

This change is especially important in areas faced with urban growth. Land values for development in these areas are much higher than for agricultural use, rendering the $750,000 cap ineffective in preserving farmland. If this cap cannot be eliminated it should, at the very least, be increased and indexed for inflation.

Farm Bureau also supports increasing the annual gift tax exemption per donee from the current $10,000 to $20,000. This would provide another tool to ease the estate tax burden and help keep farms and ranches in the family.

Keeping farms and ranches in the family has never been an easy task. The tax changes we have proposed today are a significant part of making that task just a little bit easier. We urge the committee to work for swift implementation of these measures.

TESTIMONY ON BEHALF OF THE
AMERICAN HORSE COUNCIL
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
FEBRUARY 3, 1995

The American Horse Council is the national representative for the horse industry and includes nearly 200 equine organizations representing over one million horse owners and breeders who are involved in every facet of the horse industry.

The U.S. horse industry is a very diverse $15.2 billion industry that employs and supports hundreds of thousands of workers. Horse owners and breeders spend $13 billion in annual investment and maintenance costs. $200 million worth of horses are exported each year, far more than are imported. Horse farms and training facilities provide green space, often in areas that are being threatened by encroaching urban growth.

Pari-mutuel horse racing is legal in 43 states and involves the racing of Thoroughbreds, Standardbreds, Quarter Horses, Arabians, Appaloosas and Paints. Off-track and inter-track wagering is legal in 41 states. There are over 200 racetracks in the U.S. In 1993, over 64 million people attended the races, generating over $493 million in direct revenue to states from pari-mutuel taxes, track licenses, occupational licenses, admission taxes and miscellaneous fees.

Another 40 million people view equine sports each year at horse shows and rodeos. There are 14,000 sanctioned horse shows a year with thousands of local, unsanctioned additional shows. These shows contribute $223 million annually to our economy with rodeos contributing over $100 million. 27 million people over twelve ride each year, more than half on a regular basis.

On the state level, California's horse industry generates the most dollars with a total GNP of $2 billion annually, followed by New York's $1.3 billion and Texas' $1 billion. Many other states have very substantial breeding, racing and showing industries.

The equine industry is very labor-intensive. Hundreds of thousands of individuals breed, own, train, use and care for horses. These people, who work full-time in the horse industry, include owners, trainers, grooms, jockeys, drivers and riders, veterinarians, instructors, van operators, racetrack employees and the countless others who do not work directly with the horse but whose livelihood depends on it.

According to the American Veterinary Medical Association's 1988 research study, there are 6.6 million equine in the United States. Previously, the AHC's economic impact study stated there were 5.25 million economically productive equine.

Several of the tax provisions of H.R. 9 would be, if enacted, beneficial to our industry by way of promoting both investment and job growth.

Our membership strongly supports a reduction of the capital gains rate as proposed in H.R. 9, as well as permitting a taxpayer to increase the basis in certain assets to reflect the impact of inflation during the taxpayer's holding period.

AHC and its membership are also in favor of the increase in the expense deduction from $17,500 to $25,000.

Other proposals which would be beneficial to the horse industry include:

1. The proposed neutral cost recovery system permitting the taxpayer to increase annual depreciation deductions by an inflation factor;

2. Broadening of the deduction for home office expenses; and

3. Reform of the estate and gift tax laws increasing the $600,000 exemption to $750,000.

In connection with estate tax reform, we would also favor changes which would permit family owned businesses to continue to operate rather than have to be liquidated to pay as much as 55% of the value of the estate in federal estate taxes.

We appreciate the Committee's consideration of these comments. If you have any questions, please contact the American Horse Council.

Governmental Affairs
American
Hotel & Motel
Association

1201 New York Avenue, NW
Washington, DC 20005-3931
Tel. 202/289-3120
Fax 202/289-3185

February 3, 1995

The Honorable Bill Archer
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Archer:

The American Hotel and Motel Association (AH&MA) is a federation of state and local lodging associations representing over 10,000 properties. The lodging industry employs over 1.5 million people and has annual sales exceeding $60 billion. Our association represents all of the major lodging chains and also contains a significant number of smaller properties. On behalf of our member properties we offer the following comments and request they be made a part of the record of the hearings on capital gains tax reform held January 24, 1995, through January 26, 1995.

AH&MA supports the provisions in the Contract with America to reduce the capital gains tax and index the value of assets to eliminate taxing "illusory gains" and applauds this committee's efforts in focusing on the advantages to the business community of a capital gains reduction. We believe that many hotels, including our smaller properties, may benefit from this change in several ways.

Firstly, it is likely that some investors already in the industry are holding hotels out of a reluctance to face the current level of taxation upon their sale. This reluctance to sell can artificially reduce normal turnover of property ownership and can act as a drag on our industry which is just beginning to recover from one of its worst downturns. A capital gains reduction would encourage investors to turn over appropriate properties and may even have a salutary effect on the sale price. At the same time, a capital gains tax reduction would encourage those investors to make upgrades to their properties prior to sale, knowing that their return on that additional investment would not be unduly penalized.

For those investors outside the lodging industry who are able to have capital freed by sales or dispositions of other assets, we believe investment in the lodging industry will be an increasingly attractive consideration. As our industry continues its recovery and experiences modest expansion, a change in capital gain rates along with indexing of asset value should help ensure solid growth for hotel and motel owners. The freeing up of capital both inside and outside our industry should help to stimulate the market for hotel properties.

We believe these benefits are not limited to the lodging industry and that many other industries could likely experience similar favorable results from the capital gains tax change under consideration. We look forward to final action by the Congress on this tax change.

Sincerely,

James E. Gaffigan

James E. Gaffigan
Vice President, Governmental Affairs

STATEMENT OF ASSOCIATED BUILDERS AND CONTRACTORS

Mr. Chairman, On behalf of the over 17,500 contractors, subcontractors, suppliers and related companies of the Associated Builders and Contractors (ABC), we greatly appreciate this opportunity to submit our comments on H.R. 9, the Job Creation and Wage Enhancement Act. This Act, based on the tax provisions in the Contract With America, will encourage greater savings and investment. ABC supports the entrepreneurial incentives in the Act.

ABC is a national trade association representing approximately 17,500 contractors, subcontractors, material suppliers, and related firms from across the country and from all specialties in the construction industry. Our diverse membership is bound by a shared commitment to the merit shop philosophy of awarding construction contracts to the lowest responsible bidder, regardless of labor affiliation, through open and competitive bidding. With 80% of the nation's construction workers choosing not to be represented by a union, ABC is proud to be their voice.

The construction industry accounts for 7-15% of our nation's gross national product each year and employs close to 5 million workers. It is easy to see why the improvements in the tax laws that affect the construction industry will create jobs and enhance wages. ABC is especially supportive of four proposals that will particularly affect the construction industry -- implementing neutral cost recovery, raising the limit on expensing, increasing the estate tax exemption, and the capital gains incentives. Additionally, ABC supports the notion in the Contract that there should be a tax credit for education. However, rather than credit for college, ABC believes that a tax credit for those who provide job training is more economically sound and provides realistic benefits for more of America.

Neutral Cost Recovery

The proposal to implement a system of neutral cost recovery would allow firms to deduct the full real present value of their investments. This represents a significant improvement over current depreciation allowances. The current system falls woefully short -- failing to take into account both inflation and the time value of money.

ABC believes that neutral cost recovery is a step in the right direction toward a system of taxation that encourages, rather than inhibits, growth. This step was undoubtedly arrived at by taking a realistic look at the tax provisions affecting businesses. Why should businesses lose the value of their investments to arbitrary depreciation schedules? ABC further believes that there are other arbitrary provisions in the tax code that adversely affect businesses.

For example, the Lookback Rule, an integral part of the Percentage of Completion Method of accounting, requires taxpayers engaged in the production of property under a long-term contract to engage in costly and excessive calculations. Under the Percentage of Completion Method, gross income for taxation purposes is calculated by multiplying the gross contract price by the percentage of the contract completed in the year in question. The percentage of the contract completed is determined by comparing actual costs incurred during the year with the estimated total contract costs.

Because the Percentage of Completion Method uses estimated, rather than actual, contract price and costs to figure gross income for any taxable year, the Lookback Rule is applied in the year the contract is completed. The taxpayer is then compensated for the acceleration or deferral of taxes paid over the contract term.

Application of the Lookback Rule requires a three-step process. First the taxpayer must recalculate the percentage of contract completed using actual, rather than estimated prices and costs. This first step allows any under or over reported taxable amount to be calculated. Second, the taxpayer must compare his tax liability for each year based on the income reallocated under the first step with the tax liability previously reported. In the final step, the taxpayer must apply the Lookback Method interest rate to the under or over payment and pay the interest or receive the refund accordingly.

Under the 10% de minimis rule, the contractor may complete only the first step of the Lookback Rule. If the estimated contract price and costs are within 10% of the actual contract price and costs, the contractor can elect not to proceed further in application of the Lookback Rule. Although the 10% de minimis rule provides some relief for larger contractors from the burdensome computations and excessive administrative costs, complex calculations must still be performed to determine if each contract meets the 10% rule. Small contractors typically lack the necessary resources it takes to perform these complex calculations.

Additionally, all construction contractors must make the percentage of completion and look-back calculations for purposes of the Alternative Minimum Tax. This is true despite the fact that in the 1986 Act, Congress provided an exemption for contractors with average annual revenues under $10 million dollars from the Percentage of Completion Method and the Lookback Method for regular tax purposes.

Members of the construction industry, along with other businesses requiring ongoing capital investment, are often forced into the Alternative Minimum Tax, and, therefore, into calculations under the Lookback method despite Congress' intent to exempt them. As an additional burden, the Alternative Minimum Tax subjects these companies to the worst capital cost recovery system in the industrialized world. The Alternative Minimum Tax can result in capital costs that are 20% higher than for foreign companies or those not subject to the Alternative Minimum Tax. Under the Alternative Minimum Tax, cash flow that could otherwise be used to fund new jobs or more investment is, instead, flowing into the Treasury as a punishment for investment in capital. The problem of the Alternative Minimum Tax should be addressed when Congress addresses the problems with the current system of depreciation.

Additionally, small contractors should be granted a full exemption from the Lookback Method. According to the IRS, Lookback is revenue neutral. This means that it provides no great benefit to either the Treasury, in the form of interest, or to the taxpayer, in the form of a refund. What Lookback does do is pull funds away from job creation and investment and expend them on paperwork and calculations. In fact, contractors typically spend much more in administrative compliance costs than the amount of any interest either owed or received after Lookback is calculated.

Expensing

Currently, businesses are permitted to expense, or fully deduct, the first $17,500 they invest in equipment in the year it is purchased. The Contract With America proposes raising that limit to $25,000. Expensing helps construction firms who make considerable investments in equipment by freeing up money far faster than depreciation schedules allow. This freedom encourages further investments and, therefore, speeds growth and spurs further hiring.

For these reasons, ABC supports an increase in the amount permitted to be expensed. While the proposed increase would be helpful, especially to smaller businesses, ABC supports an even higher level to encourage that much more investment.

Additionally, ABC believes that expensing should be reformed to the extent that expensing is reduced dollar for dollar when capital expenditures exceed $200,000. Also, cars and trucks, not currently permitted to be expensed should be included in the reformed provision. Often light trucks are the most critical piece of machinery purchased by a construction firm.

Capital Gains

The Job Creation and Wage Enhancement Act proposes excluding 50% of capital gains from taxation and indexing the capital gains tax rate to inflation. This proposal makes good economic sense. In fact, capital gains rarely keep up with inflation. As inflation increases over time, it becomes necessary to sell your property for much more than you paid for it to realize any actual gain. If property is sold for less than its inflation adjusted purchase price, the owner effectively takes a loss. Then, at the current rate, the government takes another 28% off what the owner did manage to recapture. It is easy to see why individuals are often reluctant to sell property and realize illusory "gains" on which they are then taxed.

Excluding 50% of capital gains from taxation and indexing the rate to inflation does not amount to a tax break for the rich. These proposed changes to capital gains taxation will free individuals to sell property and reinvest. This reinvestment is good for business and good for the economy. It will create growth, more jobs, and higher wages. Additionally, the Treasury will likely benefit from the increased realizations and resulting tax dollars.

Estate Tax

Many of ABC's members are small or family-owned businesses. The proposal in the Contract With America to raise the estate tax exemption from $600,000 to $750,000 would do much to ensure the continued existence of these businesses even after the death of an owner. Because all assets are included in estate tax calculations, many small businesses must be sold to outsiders upon the death of the owner. A construction firm with modest assets in equipment may be forced to sell to outsiders simply because it lacks the liquid assets to pay the estate tax.

Education Tax Credits – Job Training

Tax cuts, designed to stimulate economic growth and increase the number of good jobs available to Americans must be at the forefront of Congress' agenda. These pro-growth tax cuts will go far further toward accomplishing improvements in the economy than will budget reductions. Yes, it is important to get the budget in line, but this will be even easier once productivity rises and the returns start rolling in.

ABC is fully supportive of all aspects of the Contract, including tax cuts and credits for individuals in certain circumstances. For example, the tax credit for college tuition will doubtless go far to help those students actually headed for college. But what of that vast number of students for whom college is not the best answer? ABC believes that it is important to acknowledge that, while college is a great option for some, skill based training in an industry like construction may be an even better alternative for many.

There is a lot of talk in Congress about overhauling the federal job training system. ABC would like its job training program, the Wheels of Learning, to be recognized as a valuable private resource -- a model for those in the construction industry and other industries to follow. The key to job training consolidation is that resources must be pooled and first-quality training must be provided in fields in which it will be possible to obtain employment.

ABC's private training program, the Wheels of Learning, provides state of the art, Department of Labor approved, skill based training in 17 crafts. The training received under the Wheels of Learning is standardized and portable. It provides workers in the construction industry with high level, practical skills.

Unfortunately, profit margins in the construction industry are extremely slim -- often only one penny on the dollar. When money is tight, the practicality is that training is often the first cost cut. ABC believes that private training programs are a valuable asset that should be exploited by a new federal job training system. Assurance of their continued quality can be accomplished through a proven response mechanism -- the tax credit.

Obviously, the particulars of integrating private training programs like the Wheels of Learning into the federal system need to be further explored. However, one thing is clear. A tax credit to the provider of private, practical job training programs would go far to ensure the continued success of the program. A tax credit directly to the trainer would ensure that the money goes toward improving the programs available. It additionally insures that federal money goes to programs that meet national standards and specific state and local needs.

A tax credit to the trainer makes good economic sense. One centralized trainer can allocate the available money within its program to provide superior training. Its incentive is the worker shortage. By the year 2000 there will be a serious shortage of workers in the construction industry. Construction firms have every incentive to provide their workers with high quality training that will be of benefit to both employer and employee.

Congress' willingness to help Americans become better educated is admirable. ABC offers the suggestion that Congress look to the most economical method of providing that education. ABC also suggests that Congress focus on the strong, well-paying jobs available in the construction industry for which specific craft training, but not necessarily college, is a requirement.

Beyond the Contract – S Corporation Reform

The Subchapter S Corporation, which is a pass-through entity taxing its owners directly on corporate profits, was originally introduced by Congress in 1958. One of the major objectives in establishing S Corporations was to allow business owners, particularly those of small businesses to obtain the single-tier level of taxation afforded members of partnerships. The S Corporation structure recognizes that a business whose owners are generally the same as its managers should not be taxed as if the two were separate groups, earning two different sets of income. S Corporations also benefit by maintaining the limited liability of a regular C Corporation. Regretfully, however, Subchapter S, as originally enacted in 1958, was very limiting and contained a number of pitfalls.

Unfortunately, changes in the tax rules for S Corporations have not kept pace with the economic and financial changes in the business world. In fact, the 1993 Budget Reconciliation Act affected a dramatic change in S Corporation tax policy. Subchapter S Corporations now pay the highest tax rates in the country regardless of whether shareholders distribute profits or reinvest them in their business. Considering the fact that S Corporation status is the rule of thumb for small and family owned businesses, reform of Subchapter S is critical.

The guiding principle behind S Corporation reform is the elimination of barriers to growth and capital formation for these often small and family-owned businesses. S Corporations should be given access to capital sources now unavailable to them such as new kinds of debt and equity and new types of shareholders. S Corporations should have the opportunity to grow. They should be permitted to own other companies and have better ownership structures themselves. Estate planning for S Corporations should be improved to recognize realities in generational succession. Finally, obsolete tax rules that exist simply to trap unwary companies and endanger subchapter S status should be eliminated.

Beyond the Contract -- the Targeted Jobs Tax Credit

Another area ripe for reform is the targeted jobs tax credit. Reform in this area is particularly critical to small businesses. In the past, this tax credit has provided employers with an incentive to hire the structurally unemployed. It has helped approximately 500,000 disadvantaged Americans enter the workforce each year since the original bill was passed in 1978. Because the tax credit makes it easier for these individuals to obtain private sector employment, everyone benefits from reduced government costs.

The old Targeted Jobs Tax Credit expired on December 31, 1994. While the old system had its difficulties, the idea of giving a tax credit to employers who hire individuals who want to work but may be less attractive as job candidates is a good one. This is especially true considering how hard Congress is working to minimize the number of people on the welfare rolls.

The key to this type of tax credit is that the credit be the incentive for the hiring. For a small business, a couple of thousand dollars is, indeed, a great incentive. However, under the old law, the complexities associated with obtaining the credit often necessitated many hours of administrative costs and sometimes even paying to hire a consultant -- effectively eliminating the incentive for the small business owner.

The new program should incorporate objective eligibility criteria that would replace the current, local, case by case decision making. Under the old system, decision making was a burdensome and often lengthy process. In the construction industry, people are often hired for short term projects and the point is often moot by the time the certification process has been completed. Simplified administration would save money for the government and for the contractor who would no longer have to rely on the expertise of a consultant. Additionally, objective eligibility criteria would enable an immediate hiring decision to be made with the knowledge of whether or not the tax credit makes the candidate more attractive. It is a good idea to set the system up so that employers cannot get a windfall by having a candidate they would have hired anyway turn out to qualify the employer for the credit. On the other hand, multiple rejections when the contractor believed he was hiring a qualified individual create a disincentive to participate in the program.

Beyond the Contract -- Independent Contractor Status

Under current law, taxpayers must use a 20 factor common law test to determine whether a worker is an employee or an independent contractor. Whatever changes are made in the tax laws that affect independent contractors must strengthen the 20 factor test by preserving its support of independent contractor status while simplifying its application.

The same common law, 20 factor test is used by the IRS to determine compliance. The IRS generally examines the classification of workers some time after the taxpayer has made its determination of the workers' classification and after the taxpayer has filed its returns. Thus, reclassification by the IRS can result in severe penalties in the form of back taxes and interest. ABC believes that Congress and not the IRS should define independent contractor status. By clearly setting out rules that encompass the 20 factor test, Congress can protect those in the construction industry and other industries who find it mutually beneficial to utilize independent contractors.

When considering the independent contractor issue, it is critical to distinguish between wrongful classification and misclassification. In construction, wrongful classification can result in a competitive edge. Those companies not paying employee taxes or workmans' compensation can undercut the competition by offering lower bids. ABC in no way condones intentional misclassification by businesses who shirk their duties to society and their workers.

The "safe harbor" provisions in Section 530 protect taxpayers from reclassification if there is a reasonable basis for treating workers other than as employees. This reasonable basis may come from published rulings, a prior audit, or industry practice. Section 530 recognizes that taxpayers must be able to rely on reasonable methods of classification without risking bankruptcy. The protection found in Section 530 are invaluable, especially to the construction industry with its long history of industry practice.

In addition to protecting past classifications, ABC believes that the time may be ripe to clear up the fog surrounding the 20 factor test for future classifications once and for all. A clean and simple test that recognizes the valuable role of independent contractors in the small business world would ease the way of the contractor struggling with a classification and make it easier to identify wrongfully classified workers. ABC would support such clarification as long as it preserves the current, mutually beneficial industry practice of properly utilizing independent contractors.

Conclusion

ABC supports this Committee in its examination of the tax proposals in the Contract with America. ABC believes that these proposals are pro-growth and pro-economy. ABC supports the additional proposals mentioned here as further building and enhancing the Contract's foundation.

TESTIMONY OF BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

Office Buildings Create Jobs

The Building Owners and Managers Association (BOMA) International is pleased to present our perspective on two significant issues of concern to commercial real estate: the tax treatment of capital gains and the depreciation of leasehold improvements. These issues are addressed in the Job Creation and Wage Enhancement Act (H.R. 9).

BOMA is the oldest and largest association uniquely representing the office building industry. Our members collectively control over 6 billion square feet of office space -- more than half the total nationwide. After a prolonged and dismal downturn in our industry, we are encouraged that Congress is considering approaches to encourage savings, investment, and economic reinvigoration. Nowhere are such changes more welcome than in commercial real estate.

Unlock Resources

On capital gains, we strongly support the greatly lowered tax rate proposed in H.R. 9, as well as the indexation of *original capital cost* -- an appropriate approach for real estate -- to ensure that "fictional" gains from inflation are eliminated.

The high rate of tax now in place on capital gains discourages a range of activities that are economically desirable: the acquisition and development of commercial properties; lending to finance or refinance investment in those properties; and the employment of skilled workers involved in carrying out construction, renovation and remodeling work. Owners who wish to sell or dispose of a building may choose, for tax reasons rather than sound business reasons, to hold onto the property. For example, the sale of a building may result in a significant "paper gain" without sufficient cash actually being on hand to pay the tax. In such a case, a reduced capital gains rate would make the building's transfer more tenable. The approach put forward in H.R. 9 would unlock a good deal of capital in the private sector, making resources available for improving the infrastructure of America's downtowns.

BOMA also supports two provisions in this legislation that would guarantee fairness in capital gains treatment: that currently held assets should benefit from a reduced rate in the same way as newly acquired assets; and that the tax changes should apply to individually held as well as corporately held assets. Further, we are pleased that H.R. 9 would maintain the current depreciation recapture rules, which recognize that real estate assets do, in fact, depreciate.

Spur Employment

Overall, the capital gains plan contained in H.R. 9 would do a great deal to stimulate prudent investment and reasonable expansion of activity in the office building industry -- an industry that has learned its lesson from the rampant overbuilding that occurred during the 1980s. A significant tax barrier to the sale and redevelopment of commercial properties will be removed, spurring employment for the construction and modernization trades and boosting the nation's economy.

Unreasonable Schedule

A related matter is the need for changing the unrealistic way that improvements made to leased premises are depreciated under current law. Such "leasehold improvements" include changes to walls, floors, ceilings, lighting, plumbing, etc. that will meet the needs of an existing tenant or a new tenant moving into space vacated by an old tenant. While such reconfigurations or buildouts are commonplace -- the average lease length is 5 to 10 years -- improvements made to a tenant space *must now be depreciated over 39 years.* This 39-year rule applies even when improvements are no longer in effect because the given tenant has moved out or the improvements themselves have been demolished. In such cases, the owner is prevented from "closing out" and deducting in the current tax year his/her unrecovered costs connected with the improvement. Those costs must still be recovered over 39 years.

At Odds With Common Sense

This situation runs counter both to common sense and the reality of the marketplace. Over a 39-year period, the typical tenant space may be reconfigured five times or more. The improvements made in each case are only "useful" for the life of the lease or the length of time the work serves the given tenant's needs. The 39-year period is also out of sync with the expectations of lenders as to when they will be repaid by building owners for the financing of tenant buildouts. In addition, when federal government agencies lease space from the private sector, they expect rent and other costs to be broken out by the length of the lease -- not some 39-year period that bears little or no relation to reality.

Where larger offices are concerned, the cost of building out tenant spaces can exceed a half-million dollars. The lengthy depreciable period in current law has the effect of delaying or discouraging such expenditures -- including desirable upgrades to more energy efficient lighting, heating, and cooling systems.

Progressively Worse

The tax treatment of leasehold improvements has not evolved for the better. Before 1981, a reasonable policy was in effect whereby the costs of leasehold improvements could be recovered over the *useful life* of those improvements (typically the length of the lease). After the 1981 Economic Recovery Tax Act, costs had to be recovered over the same depreciable period as that of the building, which at the time was 15 years. The 1986 Tax Reform Act changed the depreciation schedule for commercial buildings (and leasehold improvements) to 31 and-a-half years. The 1993 Omnibus Budget Reconciliation Act further lengthened that period to 39 years.

BOMA urges Congress to shorten the depreciable period for commercial properties so that the costs connected with leasehold improvements can be deducted over a period that reflects the *useful life of the improvements, i.e., 10 years or the length of the lease.* Clarification is also needed so that building owners know they are permitted to close out unrecovered expenses if the construction has been permanently taken out of service. We believe this approach is necessary to address the particular situation of real estate, beyond the "Neutral Cost Recovery System" proposed in H.R. 9.

Boost to Recovery

In decreasing the capital gains tax and providing for a more rational treatment of leasehold improvements, Congress has a dual opportunity: to advance sound tax policy while facilitating real estate's economic recovery.

Our industry is finally turning the corner after its worst slump in 60 years. The nationwide vacancy rate for office buildings is inching downward, from 18.3 percent a year ago to 16.9 percent currently.* These numbers are still high, however -- and are even higher in particular markets. With the excess development of the 1980s freshly in mind, building owners realize that investment opportunities must be carefully weighed and purposefully pursued. Very few new office buildings are being built, and not many are expected to be built until existing vacant space is sufficiently absorbed. It is still a "tenant's market" in most regions of the country, so, to the extent that investments are being made and construction is occurring, the bulk of the activity stems from the renovation and remodeling of older properties. It is just such building upgrades that Congress can expect to spur with capital gains and depreciation changes -- not a headlong rush to new construction.

Traditionally, real estate powers America's economic engine. We are in position to boost the recovery now taking place through the unlocking of capital and by returning to a sensible method for depreciating leasehold improvements. BOMA welcomes Congress' consideration of such changes, and we look forward to having the Ways and Means Committee enact this fair, necessary and productive legislation soon.

* (Figures taken from BOMA's 1993 and 1994 *North American Office Market Review)*

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Founded in 1907, the Building Owners and Managers Association (BOMA) International is a dynamic federation of 98 local associations whose members own or manage over 6 billion square feet of commercial property in North America. The membership -- composed of building owners, managers, developers, leasing professionals, facility managers, asset managers, and providers of goods and services -- collectively represents all facets of the commercial office building industry. BOMA is firmly established as the respected resource on national matters affecting the industry.

STATEMENT
of
COMMONWEALTH EDISON COMPANY
before the
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
regarding the
NEUTRAL COST RECOVERY SYSTEM
proposal of the
JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995 (H.R. 9)
February 3, 1995

INTRODUCTION

This statement is being submitted by Richard P. Roling, Assistant Comptroller, Commonwealth Edison Company, on behalf of Commonwealth Edison. Commonwealth Edison is an investor-owned electric utility serving more than 3.3 million customers and 8.1 million people in the northern one-fifth of the state of Illinois, including the city of Chicago. Commonwealth Edison appreciates the opportunity to submit its views of the neutral cost recovery system (NCRS) proposed in Section 2001 of the Job Creation and Wage Enhancement Act of 1995 (H.R. 9) and respectfully requests that this statement be made part of the record of the hearings on the tax provisions in the Contract with America.

The capital requirements of producing, purchasing, transmitting, distributing, and selling electricity to wholesale, industrial, commercial, and residential customers are quite substantial. Commonwealth Edison forecasts a need to invest approximately $3.1 billion in electric utility property (i.e., nuclear and steam production property, transmission and distribution plant, and nuclear fuel assemblies) during 1995 through 1997 in order to serve its ratepayers in accordance with its obligations as a public utility. Accordingly, Commonwealth Edison is very supportive of Congressional recognition of the need for, and its efforts to provide, tax incentives in the Internal Revenue Code to encourage capital formation by U.S. companies.

This need was most recently addressed in legislation by a modification to the alternative minimum tax (AMT) provisions in the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66). The modification repealed the adjusted current earnings (ACE) depreciation adjustment prospectively for property placed in service in tax years beginning after December 31, 1993. (The ACE adjustment had the effect of partially negating the tax deferrals provided by the modified accelerated cost recovery system (MACRS).)

The NCRS proposal is a major improvement to the current depreciation system, MACRS, in terms of encouraging capital formation. Commonwealth Edison enthusiastically endorses the goals of the NCRS proposal and generally supports the mechanics of the provisions of H.R. 9 which modify the current depreciation rules. The feature of importance is the inflation adjustment. However, in order for a public utility to fully achieve the capital formation incentives intended by the NCRS proposal, the proposal must contain normalization requirements to provide guidance as to the ratemaking treatment of the tax benefits. Normalization requirements have been included in every major modification to the depreciation rules since the Tax Reform Act of 1969. Public utilities may not realize the same incentives as other industries if normalization requirements are absent from NCRS because some rate-setting public utility commissions could flow through the tax savings to existing customers rather than allow the utilities to reinvest the savings in their plants.

Commonwealth Edison also offers a recommendation to simplify the calculation of the inflation adjustment and comments on the disadvantages to certain industries resulting from the inequity in computing the annual inflation adjustment for long-lived assets relative to short-lived property.

NEED FOR A NORMALIZATION REQUIREMENT

Whether or not the Congressional intent of encouraging capital formation may be achieved by rate-regulated companies will be decided by state and public utility commissions unless a normalization provision is added to the NCRS proposal. The incentives that would be granted by Congress under NCRS are similar to the excess deferred tax reserves created as a result of the reduction in the corporate income tax rates from 46 percent to 34 percent by the Tax Reform Act of 1986 and to the tax savings resulting from the investment tax credit (ITC) provisions existing at various times between 1962 and 1986. Both the reduction in tax rates and the provision of an ITC created permanent benefits to taxpayers, including utilities. Both of the tax benefits were accompanied by normalization provisions to regulate the sharing of tax benefits between utilities and their ratepayers. Similarly, Commonwealth Edison believes that the sharing of incentives in the NCRS proposal should be governed by normalization provisions in order to achieve intent of Congress.

* * * * *

In 1954, Congress rewrote the Internal Revenue Code. Among the provisions included in the rewritten Code was the right of all taxpayers to claim depreciation allowances that were based on other than a straight-line method, which was, and still is, the method generally used for financial reporting purposes. The 1954 Code provided methods (double-declining balance, sum-of-the years' digits, etc.) that do not change the total amount of tax depreciation, but allow greater amounts in earlier years and offsetting lower amounts in later years. Subsequent additions and revisions to the Internal Revenue Code included the (a) Asset Depreciation Range (ADR) provisions of 1971, which reduced tax lives, (b) the Accelerated Cost Recovery System (ACRS) in the Economic Recovery Tax Act of 1981, which continued to allow acceleration of tax deductions, and (c) the Tax Reform Act of 1986, which reduced but did not eliminate the acceleration.

Congress stated in the Committee Reports accompanying these pieces of legislation that the incentive of accelerated depreciation was being granted by Congress to all taxpayers for purposes of encouraging the modernization of the nation's industrial facilities and improving productivity. (Similarly, Representative Nick Smith, who introduced NCRS in H.R. 539 and H.R. 9, advocates NCRS as a means to encourage businesses to invest in machinery and equipment.) The economic effect of the incentive of accelerated tax depreciation over straight-line depreciation is equivalent to an interest-free loan from the U.S. Treasury to the taxpayer. This loan, measured by the tax rate times the difference between accelerated depreciation and straight-line depreciation, builds up in the earlier years of a property's life and then is repaid in the later years. It is important to recognize that the only benefit of accelerated depreciation to taxpayers is an interest-free loan provided by the postponed, but not forgiven, tax payments. The principal of the loan has to be repaid. Because Congress has made these interest-free funds available during the life of the property, less outside financing is required, thereby reducing financing costs. These reduced financing costs are realized over the life of the property. This benefit granted by Congress is available to all taxpayers.

Congress initially did not provide guidance as to the ratemaking treatment of these benefits. Some regulatory commissions reduced the rates charged to current customers by the amount of the loan itself, rather than the value of the interest-free nature of the loan. Passing the principal of the interest-free loan to customers is referred to as "flow-through" ratemaking. These commissions implicitly assumed that the utilities would recover these costs in the form of higher rates from future ratepayers. A majority of regulatory commissions, however, adopted ratemaking procedures which reduced customer rates by only the reduced financing costs. These commissions generally passed on to customers the real economic benefit of these loans by requiring that the accumulated deferred income tax balances (i.e., the loan to be repaid) be deducted from the utility company's rate base on which it was entitled to earn a return. This type of ratemaking, referred to as "normalization," is more beneficial and equitable to customers in the long run and is consistent with the Congressional intent of reducing financing costs over the life of the property. Congress ultimately enacted normalization provisions to incent regulatory commissions to use normalization ratemaking in setting utilities' rates.

It is important to note that Congress has not required the regulatory commissions to follow any particular form of ratemaking. Rather, Congress indicated that if a regulatory commission were to follow ratemaking procedures with respect to tax incentives that created economic results contrary to the intent of Congress in granting such incentives, those incentives would no longer be available to the taxpayer subject to such ratemaking procedures. The practical effect, of course, is that regulatory commissions recognized the benefit to customers of these interest-free loans and did not want to do anything that would jeopardize the right of the utility companies to utilize them.

The reduction in the corporate income tax rate in the Tax Reform Act of 1986 from 46 percent to 34 percent, had the effect on all taxpayers of reducing the loan that must be paid back to the U.S. Treasury. Congress essentially forgave a portion of the interest-free loans outstanding at December 31, 1986. Although a portion of the interest-free loans has been forgiven, Act Section 203(e) specifies that the related economic effect should continue to be handled in a manner consistent with the Congressional intent for providing accelerated depreciation as a tax incentive for plant modernization and improved productivity. The average rate assumption method mandated by Act Section 203(e) provides that the excess tax reserve resulting from the forgiveness must not be reversed (i.e., used to reduce rates) any more quickly than the timing difference between the book and tax depreciation method reverses. Congress chose not to allow utilities to permanently retain the tax benefit and chose not to flow the benefit through immediately to current ratepayers. Instead, Congress opted for an equitable sharing among utilities, current ratepayers, and future ratepayers.

Commonwealth Edison believes that the tax savings under NCRS, which are economically similar to the excess tax reserves normalized under Act Section 203(e), should also be governed by a normalization provision so that the tax benefit is shared among utilities, current ratepayers, and future ratepayers. Otherwise, the opportunity of achieving the Congressional intent of fostering capital formation may not be attainable by rate-regulated utilities.

Congress has allowed an ITC at various times between, generally, 1962 and 1986 in order to encourage capital formation by taxpayers. Credits, including the ITC, provided in the Internal Revenue Code have the effect of reducing tax liability on a dollar-for-dollar basis. Unlike accelerated depreciation, which results in the temporary benefit of an interest-free loan from the government to taxpayers, ITC results in a permanent benefit to taxpayers. ITC, therefore, is a powerful incentive to taxpayers to invest in qualifying property. The benefit generated by ITC is economically similar to the forgiveness of the interest-free loan resulting from the reduction in tax rates in the Tax Reform Act of 1986.

Congress intended the ITC to be an incentive for modernization and growth of private industry; it did not intend for the ITC tax benefits to be used to immediately reduce rates of current ratepayers. Accordingly, Congress enacted a normalization provision for ITC in the Revenue Act of 1971 to mandate an equitable sharing of the tax savings arising from ITC among utilities, current ratepayers and future ratepayers. Normalization provisions have also been an integral part of all subsequent ITC allowances in the Internal Revenue Code.

The incentives underlying the NCRS proposal, including the inflation adjustment, are similar to that of other accelerated depreciation systems and the ITC. Congress recognized that both incentives needed normalization requirements in order to achieve their capital formation purpose. The economic benefits of NCRS inflation adjustments are economically similar to that of the excess deferred tax reserves created as a result of the reduction in the corporate income tax rates from 46 percent to 34 percent by the Tax Reform Act of 1986 and to the tax savings resulting from ITC. Again, Congress recognized and provided normalization requirements for these tax benefits. Accordingly, Commonwealth Edison believes it is appropriate and necessary for Congress to provide normalization requirements under NCRS for the inflation adjustments in order to allow utilities the same incentives and opportunities for capital formation as non-rate-regulated companies.

SIMPLIFICATION OF CALCULATION OF ANNUAL INFLATION ADJUSTMENT

The mechanics of determining NCRS depreciation adjustments, which aim to provide the approximate economic equivalent of currently deducting the cost of assets, involve the indexing of depreciation deductions for inflation. Briefly, depreciation for a NCRS asset in a given year would equal depreciation based on the 150 percent declining balance method multiplied by the "applicable neutral cost recovery ratio." The applicable neutral cost recovery ratio for a given recovery year is based upon the gross domestic product deflator for the calendar quarter the asset is placed in service as well as the gross domestic product deflator for such recovery year.

Under MACRS, taxpayers generally use a single depreciation rate in a given recovery year for personal property within a single asset class placed in service in the same tax year. The only situation in which quarterly records (i.e., different depreciation rates for a given recovery year for personal property within a single asset class placed in service in different quarters of the same tax year) are required to be maintained under MACRS occurs when a taxpayer does not meet the requirements of the half-year convention. (A taxpayer may not use the half-year convention and must use the midquarter convention for personal property of any vintage year in which 40 percent or more of its personal property additions are placed in service in the last quarter of the year.) The proposed calculation of the applicable neutral cost recovery ratio would needlessly cause the vast majority of taxpayers mandated to use the half-year convention to increase their record-keeping burden. Commonwealth Edison believes that basing the calculation of the applicable neutral cost recovery ratio for taxpayers using the half-year convention on a single gross domestic product deflator (i.e., the deflator for the month closest to the date the property is deemed to be placed in service under the half-year convention) would likely have an immaterial effect on the aggregate NCRS depreciation adjustment for assets within a given asset class relative to the proposed method of using four deflators per year. Commonwealth Edison, therefore, recommends that the selection of the gross domestic product deflator under the NCRS proposal be consistent with taxpayers' applicable convention under IRC Section 168(d) so that administrative complexity is not needlessly created. The calculation as proposed would be used for property vintages to which the midquarter convention applies and the calculation under NCRS would be revised for taxpayers subject to the half-year convention to be consistent with the current MACRS requirement of using a single depreciation rate for property within each asset class of each vintage year.

INEQUITY TO INDUSTRIES USING LONG-LIVED PROPERTY

One of the stated reasons for the NCRS proposal is recognition that MACRS depreciation deductions do not allow businesses to recover the true economic cost of their business investments. The NCRS proposal is intended to increase depreciation deductions to approach the economic equivalent of expensing capital additions. This is achieved by indexing depreciation by the applicable neutral cost recovery ratio. For short-lived personal property, the ratio is based upon a 3.5 percent annual return and actual inflation. For 15-year and 20-year personal property, realty, and certain other property, the applicable neutral cost recovery ratio is based solely upon actual inflation. Under the proposal, businesses investing heavily in such property would not be afforded the same opportunity to achieve true economic cost recovery on such assets as would businesses investing primarily in short-lived assets. Industries investing heavily in assets which would not qualify for the full NCRS adjustment include, but are not limited to, electric, gas, water and sewer utilities, railroads, telecommunications providers, cement manufacturers and real estate lessors. Commonwealth Edison believes it would be inequitable to favor certain industries over others under a revised cost recovery system described as "neutral." Commonwealth Edison recommends that this disadvantage be eliminated by providing for a full NCRS adjustment for all assets.

Testimony of
Robert E. Friedman* and Cicero Wilson**
Corporation for Enterprise Development***
Before the Committee on Ways and Means of the
U.S. House of Representatives

Hearings on Savings and Investment Provisions of the
Contract With America
January-February, 1995

Mr. Chairman and Members of the Committee:

Thank you very much for the opportunity to submit this testimony on the provisions of the American Dream Savings Account ("ADS Account") for your consideration.

For the past fifteen years the Corporation for Enterprise Development (CFED), a national, non-profit economic development policy organization, have been working largely at the state and community level to develop and test effective strategies for creating enterprises, jobs and viable economies in low income communities. To that end, we have helped a number of states develop comprehensive economic development strategies, and have issued The Development Report Card for the States (generally regarded as the auditing standard for state economic health) for 8 years. We sponsored the five-state Self Employment Investment Demonstration for welfare recipients, and helped create the national microenterprise movement. We have helped a number of states craft human investment and welfare reform initiatives, including Iowa's Family Investment Program which has already resulted in a 70% increase in employment and a 7% reduction in average grant levels. Finally, we have been leading advocates for asset-building anti-poverty strategies, and have worked to launch Individual Development Account demonstrations at the community, state and Federal levels.

The American Dream Savings Account proposal recognizes the importance of encouraging savings and investment in education and home ownership not only for the economy as a whole, but for the long term welfare of all American families -- including low income Americans. This represents an important departure from traditional policy which has subsidized asset acquisition for the non-poor while it has actually penalized asset-acquisition by the poor. Unfortunately, as currently written, American Dream Savings Account proposals would continue this discriminatory policy: for example, the Administration's proposal and S. 12, the "Savings and Investment Act of 1995," would devote tens of billions of dollars worth of tax expenditures to subsidizing the savings of non-poor Americans as an entitlement with no evaluation measures, while for the poor it would simply allow asset acquisition, and then in a time-limited demonstration subject to rigorous evaluation requirements. This hardly levels the playing field -- a playing field that is dramatically uneven both in terms of the existing distribution of assets, and in the weight of current policy. At the same time, we believe the American Dream Savings Account proposals have great promise for building families, communities and the economy as a whole if amended.

We recommend that the "Savings and Investment Act of 1995 and similar proposals be amended to provide a refundable tax credit equivalent in value to the tax deductions provided the non-poor to savings placed in the ADS Accounts of Americans in households with incomes below $25,000 per year.

We also recommend that the allowable uses of the ADS Accounts be expanded to include "verifiable investments in the business of an account holder."

We have calculated that this investment in the economic futures of low income Americans will yield returns several times greater that the initial investment requires. It will create jobs and businesses, expand home ownership and skill levels, increase incomes and business revenues, strengthen families and community economies, and increase tax revenues and GNP. Perhaps most importantly, these changes would extend an investment system to low income Americans, and in so doing, would reintroduce the American Dream into thousands of communities and millions of households who have ceased to hope.

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* Robert E. Friedman is Chairman and Founder of the Corporation for Enterprise Development, author of the book <u>The Safety Net as Ladder: Transfer Payments and Economic Development</u>, and has spent the last two decades researching, developing, demonstrating and disseminating economic development strategies.
** Cicero Wilson, Project Director with the Corporation for Enterprise Development, formerly headed the Neighborhood Revitalization Program at the American Enterprise Institute, and has run youth programs, small businesses, and evaluated and researched program and policies for Abt Associates.
*** The Corporation for Enterprise Development is a national non-profit economic development policy research and consulting organization founded in 1979.

I. Building assets of all Americans -- including low income Americans -- is critical to individual welfare and national economic prosperity.

As Michael Sherraden argued in his seminal book, Assets and the Poor: A New American Welfare Policy[1], people escape poverty and achieve wealth through asset acquisition, not simply income. Owning assets give people a stake in the future -- a reason to save, to dream, to invest time, effort, resources in creating a future for themselves and their children. As Sherraden notes, "Income may feed people's stomachs, but assets change their heads."

In the earliest stages of this Republic, Thomas Jefferson recognized that property-holding lay at the heart of full participation in American political, social and economic life. In Assets and the Poor, Sherraden notes that people escape poverty the same way they achieve wealth: through asset acquisition. Accumulating even a small pool of savings buffers a family from the illnesses and accidents that otherwise become crises; they give the luxury of imagining a future brighter than the present; they enable people to plan and prepare for that future, and ultimately to invest in themselves and their children. People are often surprised at the suggestion that welfare recipients who scarcely have adequate resources to eat or find shelter might be willing to save money. But in public housing complexes and poor communities around the country families choose to forgo current consumption and put a few dollars away... because that is the price of family stability, the price of hope. It is people without hope that have children they can't care for and trifle with their own lives and those of others; "Assets," notes Sherraden, "are hope in concrete form."

Indeed, some of the most successful economic and social policies in our history -- policies which produced significant, long-term, widely shared economic growth -- have been democratic investments in the assets of common Americans. The Homestead Act, wherein we provided 160 acres and a mule to Americans willing to work the land, under girded the development of whole states (and the families that built them). Through the GI Bill, we bought college education's for a generation of people who served their country in time of war; they in turn drove our post-war economic expansion. Now we need to offer a way back in to the economic mainstream for the third of our nation that is falling behind and away with each passing year.

II. Both the distribution of assets and our policies for building assets are dramatically unequal and discriminatory.

One third of American households have no or negligible investable assets.[2] Twice that -- some 67% of African Americans -- are asset-poor. And asset poverty has been increasing for at least two decades.[3] This comes at a time when the price of entry to the American economic mainstream -- measured in terms of the cost of an adequate education, business capitalization or home ownership -- has increased. Asset owning has become a sort of economic grandfather clause, every bit as insidious as the voting clauses of days passed that said you could only vote if your grandfather did.

This pattern of asset-holding is abetted by a bifurcated national policy: we subsidize asset acquisition for the non-poor to the tune of $160 billion annually at the Federal level in the form of the home mortgage deduction and retirement savings incentives. Meanwhile, we actually penalize asset acquisition by the poor by denying eligibility to welfare recipients who exceed the $1000 asset limitation by acquiring the piece of business machinery that could enable them to create their own job, or saving for their or their children's college education, or acquire a car capable of reliable transportation to work.

American Dream Savings Account proposals like S. 12 recognize that low income Americans have an interest in developing assets and would therefore raise the asset limits which currently prevent AFDC, Food Stamp recipients and other low income Americans from acquiring assets. But, unfortunately, as currently proposed, proposals like the "Savings and Investment Incentive Act of 1995" would continue the discriminatory bifurcated policy that offers tens of billions of tax incentives to the non-poor while leaving most poor and working poor out. To the credit of the sponsors of this legislation, it does address the issue of assets for the poor -- it contains provisions that would lift the asset penalties for AFDC savers noted above. But while it would allow the poor to accumulate assets in a demonstration under rigorous evaluation requirements, it would provide tens of billions of dollars in tax incentives to the non-poor as an entitlement and without any evaluation.

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[1] Michael Sherraden, Assets and the Poor: A New American Welfare Policy, Armonk, NY.: ME. Sharpe, Inc., c1991.
[2] M.L. Oliver and T.M. Shapiro, "Wealth of a Nation: At Least One Third of Households are Asset-Poor," ***The American Journal of Economics and Sociology***, vol. 49, No. 2, April 1990. pp 129-150.
[3] Ibid.

We need to develop policies which will help all Americans, including welfare recipients and the working poor willing to work and save, build the assets which they need to achieve self sufficiency for themselves and growth for the economy.

There are several Individual Development Account (IDA) pilot projects currently being operated by churches, corporations and community based organizations around the country -- in places as far flung as Tupelo, Mississippi, Indianapolis, Indiana and Bozeman, Montana. "I Have A Dream" Programs in 44 cities promise college tuition's to students who stay in school; savings clubs proliferate in public housing complexes where women match each others savings to provide an emergency fund all can tap; banks and churches are developing home ownership programs wherein savings for down payments on houses are matched; and low income entrepreneurs build up assets in their businesses. Six states have sought or been granted waivers which allow AFDC recipients to build up savings in qualified asset accounts. Iowa has authorized a pilot program of Individual Development Accounts under which the state will provide refundable tax credits to Iowans below 200% poverty. Oregon's Jobs Plus program provides that employers who hire welfare recipients with a hiring subsidy paid for by cashing out AFDC and Food Stamp benefits deposit $1 for each hour worked into an IDA earmarked for future education and advancement. More states, organizations as diverse as the Congress of National Black Churches, the National Federation of Community Development Credit Unions, banks, and thousands of microenterprise programs and neighborhood development corporations stand eager to launch IDA programs if only the Federal government will become a partner.

If we would know the potential efficacy of such policies, we may look to our own history, or to other countries. Japan financed much of its post-war recovery through the small savings of common citizens prodded by the availability of Postal Savings Accounts. Singapore has built its whole social policy around government incented private savings in the Central Provident Fund. Not only has the system resulted in home ownership rates now exceeding 92%, but it has resulted in the highest level of foreign reserves per capita of any nation on the globe.

III. American Dream Savings Account proposals should encourage and support the savings and productive investment of low income Americans to the same degree that they encourage those of wealthier Americans.

What is good for the non-poor is good for the poor. ***We recommend that these "super-IRA" or "American Dream Account" proposals be amended to add a refundable tax credit equal in value to the benefit conferred on higher income savers for American households with less than $25,000 a year in household income.*** These tax credits should match all savings in a qualifying account up to $500 per year up to a total of $1,000 - 2,000. This would encourage private, state and local matches. The refundable tax credit could be deferred until withdrawal from the account.

More specifically, we would recommend that such a tax credit provide a:

- 100% match to the savings in the ADS Account of a individual below the poverty line 100% up to $500 per year for up to four years;
- 50% match to the savings in the ADS Account of a individual between the poverty line and $25,000 per year up to $500 per year for up to four years.

There are a number of reasons for extending asset building incentives to low income communities in this way, but chief among them are:

- **Fairness:** The proposed ADS Accounts represent a national tax commitment numbering in the tens of billions of dollars over the next ten years; a reasonable portion of this should accrue to the benefit of low income Americans, especially given that they cannot participate in the $160 billion of asset subsidies we currently provide the non-poor for home mortgage and retirement savings. The proposed ADS Accounts would provide a tax benefit in excess of $600 to the average taxpayer who saved $2,000 per year and withdrew the savings in year 5 (his or her tax benefit would grow each year thereafter). We should extend this benefit to low income savers as well.

- **Need for an Inclusive Investment Policy:** Ever since the New Deal, we have spent on the poor, but have not invested in them. The limits of that almost exclusive reliance on consumption maintenance and social services has helped curb the pain and effects of poverty, but has not affected its causes. Now we need an inclusive investment policy which encourages and enables low income Americans to build their productivity and ours. We need an asset policy to augment income policy.

- **Earned:** Low income Americans would only get the benefit of tax credit if they chose to save, with the immediate sacrifice that implies for families living on such limited income.

- **Productivity of Capital:** One of the major criticisms of savings incentives like those for IRAs or the proposed ADS Accounts is that rather than inducing net new savings, the subsidy simply induces a transfer of savings from non-subsidized to subsidized forms. In the case of low income Americans, however, the likelihood of such shifting is much less, and any savings are most likely to represent a shift from consumption to investment.

- **Political Support:** Making ADS Account incentives include low income Americans could draw support from quarters likely otherwise to oppose the proposals. Already Individual Development Account proposals which aim at helping low income Americans build assets have drawn excitement and support from groups as diverse as the National Congress of Black Churches, the National Federation of Community Development Credit Unions, and political leaders as diverse as Bill Bradley, Orrin Hatch, Tony Hall, Bill Emerson, Cardiss Collins, Jack Kemp and Bob Woodson.

- **Leverage:** Community groups and states stand ready to launch ADS Account initiatives and leverage Federal investment if only given the signal.

Costs and Returns: The extension of a refundable tax credit to low income Americans is not an inexpensive change. Assuming an average benefit of $250 per low income saver per year, and that only one in five eligible Americans opts to participate, we estimate an annual cost of $1-2 billion once withdrawals are permitted.

But we calculate that the direct proceeds to the Federal government -- ignoring the returns to individuals and the society at large -- will exceed $4 for each dollar invested over a 10 year period. States will get back $5 for each dollar invested and participants would receive $7 in benefits for each dollar invested.

These figures assume that one-half of the outputs noted above would have occurred otherwise; that is, we cut the estimated returns in half. They do not quantify expected changes in hope, initiative taking, family stability, civic participation, and involvement in childrens' educations.

American Dream Savings Accounts for low income families represent the center of a new investment policy in contrast to the current income/consumption maintenance policies. We use investment in the old-fashioned and precise sense of an application of resources today that creates greater returns tomorrow. We at CFED have recently estimated the likely outputs of an investment in IDAs, and will soon release a return on investment analysis based on the best available data. We estimate that 100,000 accounts with an average personal saving of $10 a month by low income Americans, matched 1:1 by private individuals and state and local governments, with the Federal government matching those contributions will produce in 10 years (please note that these are preliminary calculations which are subject to change):

- Over 46,000 job-years, at
- 6,000 new businesses
- $150 million in business revenues
- 4,500 new homes built
- 3,000 more college graduates
- 11,000 High School dropouts now getting a HS degree or equivalency
- Medicaid savings of over $171,000,000
- Welfare savings of nearly $37,802,000
- $419,502,000 in savings

Estimating an internal rate of return on this investment, the Federal government's return is 30%; the state government's return is 39%; and the rate of return for the average participant is 154%, well above the interest in Treasury bills.

In a larger sense, of course, these projections are like the returns included in the business plans of proposed ventures: we will never know the true returns unless we risk the investment.

Other Recommendations:

Recommendation 2: Extend the permissible uses of ADS Accounts to include "verifiable investments in the business of an account holder." We assume that business investments were left out because of the greater difficulty of policing such investments and the greater possibilities of fraud. But the benefits of greater entrepreneurship in terms of jobs, community and economic development, competitiveness and skill-building are so great that we should accept some reasonable risk to seize these benefits. Between 1989 and 1991 (the most recent period for which this data is available), for example, microenterprises involving only the self-employed owner and 1-3 family members or colleagues created virtually all of the net new jobs in the country (some 2.6 million jobs net).[4]

Investments in business equipment and business leases should not be appreciably more difficult to verify than tuition and mortgage payments; they are similarly large and made out to third parties. Moreover, banks or reputable business assistance providers willing to verify payments according to a written business plan should be able to provide reasonable assurance that ADS Accounts were used as intended. At any rate, the burden of proof can be shifted to the taxpayer to provide reasonable proof.

Recommendation #3: Provide an up-front tax deduction/credit as IRA's do now rather than the back-ended deduction/credit upon withdrawal. This increases the early costs of the proposal, but it allows a more honest accounting of costs, and increases the power of the incentive.

[4] "New Data Show Smallest Firms Are Nation's Greatest Job Creators," Washington, D.C.: Small Business Administration, Press Release, September 30, 1994.

TESTIMONY OF JAMES A. DOUTT
FALMOUTH, MA

There is, before the House ways and means committee (Advisory # FC-2), a proposed tax measure which would adjust capital gains for inflation. I strongly believe that passage of such a measure is ESSENTIAL.

The present system is grossly unfair. I an willing to support the activities of my government through taxation of income I receive. However my blood boils when I have a "phantom gain" (a loss when inflation is taken into account) and am forced to pay tax on it.

The success of the US tax system depends on treating the taxpayers fairly in order to ensure the taxpayers willing compilance. That is not being done with capital gains under the present system.

I also support the idea of allowing homeowners who sell their homes at a loss to take a capital loss deduction. Of course, inflation should be taken into account when determining the gain (or loss) when selling the home.

In addition, I support the increase in the estate and gift tax exemption, and the indexing of it for inflation.

I strongly encourage your committee to support such reform.

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Mr. Chairman, and members of the Ways and Means Committee, The ESOP Association submits this written testimony to address various issues that have surfaced during the Committee's hearings on the tax provisions of the "Contract with America".

This written submission is from The ESOP Association, and was primarily prepared by J. Michael Keeling, president.

The ESOP Association represents approximately 1,100 U.S. companies that are all or partially owned by their employees through an Employee Stock Ownership Plan, or ESOP. The Association's activities and services are open to the approximate 1 million American employees participating in these companies' ESOPs. As a Code Section 501(c)(6) organization, the Association is the only entity in America that communicates regularly with Federal decisionmakers on policies and ideas that may impact employee ownership in America.

Originally, The ESOP Association felt that submitting testimony on the tax provisions of the Contract with America was not appropriate, as there is nothing in the Contract that deals directly with employee ownership or ESOPs. We wish there were, but this is just not the case.

An advantage of submitting written testimony to the Ways and Means Committee versus testifying verbally is that the submitter can review the testimony and dialogue from others before putting pen to paper.

We note that many groups representing American business have come to your Committee recommending alterations and additions to the Contract as it pertains to estate taxes, capital gains taxes, and investment cost recovery by U.S. corporations.

Given the fact that over recent years a significant number of the members of the Ways and Means Committee has expressed support for legislation entitled the "ESOP Promotion and Improvement Act", and given the fact that the legislation contains provisions related to the specific topics expanded during the Committee hearings, The ESOP Association feels that it is appropriate to link certain tax ideas that do relate to ESOPs and current and proposed tax law changes pending before the Committee.

(For example, 10 members of the Committee, 9 members of the majority, and 1 member of the minority, sponsored H.R. 2088 during the 103rd Congress, the "ESOP Promotion and Improvement Act" of 1993.)

Specifically, on several occasions in recent weeks, the Committee has heard that small business needs certain alterations in the Contract proposals affecting small business. The suggestions are made in a positive sense in that the alterations are put forth as coming closer to the goals of the Contract than the specific proposals embodied in legislation that was to implement the Contract.

Everyone agrees that a significant number of small businesses operate as Subchapter S corporations, and that assisting those corporations assist small business as a general rule.

The ESOP Association respectfully suggests that now is the time to amend the Subchapter S laws to permit a Subchapter S corporation to sponsor an ESOP, and thus employee ownership. H.R. 2088 contains such a provision, designed to limit, or even enhance revenue adjustments if Sub S's are permitted to sponsor ESOPs.

Many business leaders have come to the Committee pointing out that the cost recovery provisions of the legislation to implement the Contract are not as helpful compared to other things the Committee could do in the area of business taxation. Frequently suggested is outright repeal of the corporate alternative minimum tax. Should the Committee open up a deliberation on the corporate alternative minimum tax, we ask that you review the IRS's retroactive regulations, that imposed a tax on ESOP deductible dividends, many first paid in 1987, because of an 1989 amendment to the corporate alternative minimum tax.

The unfairness of the IRS position is real, and the ESOP community would welcome the opportunity to go over this IRS regulation and the provision of H.R. 2088 that clarifies that the Congress never enacted any provision supporting the IRS position.

And, the Committee has heard much about the unfairness of the estate tax on small and family businesses. Discussion about raising the estate tax deduction limit is strong. H.R. 2088 contains a provision that the Committee might review if it alters the estate tax provisions of the Contract. From 1987 until late 1989, a small business could accept employer securities from an estate of a significant shareholder, put those securities in an ESOP, and assume the estate tax liability of the deceased. This provision of law never resulted in a loss of Federal revenue greater than $5 million per year. It would open another option to expand employee ownership in a manner that preserves small, closely held businesses.

But clearly, the heaviest debate surrounding the Contract and its tax provisions arise in the area of capital gains, and the rate of tax to be applied to long term gains. Many have suggested expanding the Contract provision, others shrinking, and some suggest forgetting it.

Again, if the Committee commits to moving into a variety of issues involving capital gains, The ESOP Association feels that a provision of law permitting capital gains tax deferral under certain conditions if the gains arise from a sale to an ESOP is currently not as fair as it should be. Under current law, an employee who holds stock because of his/her status as an employee is not permitted to sale the stock to an ESOP and defer the capital gains tax under Code Section 1042, whereas a person who holds stock otherwise can. In other words, an employee with stock as a result of stock option, stock purchase, stock compensation, etc. cannot sale to the ESOP and defer the capital gains tax. This restriction should be lifted.

In all of the four matters mentioned above, the revenue impact is not significant. The subchapter S provision would result in taxes paid through the UBIT provisions of the Code; the correction of the IRS AMT position is a clarification of law; the estate tax provision never cost more than $5 million per year; and the entire Code Section 1042 provision is scored at a revenue less of less than $50 million per year, and thus an expansion should be a significantly smaller amount than $50 million.

The ESOP Association appreciates the opportunity to submit this statement to the Committee, its members, and its staff.

STATEMENT OF

HOME OFFICE ASSOCIATION OF AMERICA
SUBMITTED TO
HOUSE COMMITTEE ON WAYS AND MEANS

RELATING TO THE SAVINGS AND INVESTMENT HEARINGS

February 2, 1995

Chairman Archer, Representative Gibbons, and Members of the Committee on Ways and Means, my name is Richard Ekstract. I am Chairman of the Home Office Association of America ("HOAA"), an organization dedicated to serving the needs of individuals whose offices are in their homes. I appreciate the opportunity to submit testimony on two issues of vital importance to HOAA: the home office expense deduction and the self-employed health insurance deduction.

Background on Home Office Expense Deduction Issue

Up until enactment of the 1976 Tax Reform Act, taxpayers were able to take liberal advantage of home office deductions for most types of work conducted at their personal residences, either as an ordinary and necessary business expense under tax code section 162 or as an expense for the production of income under section 212. In response to perceived abuses of the deduction, Congress enacted section 280A, which sets forth rules and limits on the deductibility of expenses attributable to the business use of homes for individuals and S Corporations.

These rules and limitations no longer reflect the realities of how individuals work in today's world. Section 280A states that no home office deductions are allowed unless the deduction meets specific, and in our view overly complex, statutory requirements. It is virtually impossible for a large number of home office workers to qualify under these rules, and those that qualify cannot be sure that they do.

The rules state that the portion of the home that is used for business must be used exclusively on a regular basis,1/ and in only one of the three following ways: (1) as the principal place of business for any trade or business;2/ as a place normally used by clients, patients, or customers;3/ or in connection with the taxpayer's trade or business if the taxpayer is using a separate structure unattached to the personal residence.4/ Of these additional requirements, we have found that defining a taxpayer's

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1/ *See* § 280A(c)(1).

2/ § 280A(c)(1)(A).

3/ § 280A(c)(1)(B).

4/ § 280A(c)(1)(c). Two additional exceptions are provided in the statute which do not require exclusive use of a portion of a residence. A taxpayer in the business of selling products at retail or wholesale may take deductions allocable to space within the residence which is used on a regular basis as a storage unit for *inventory* of the business. This exception is only available if the residence is the sole fixed location of the business. *See* § 280A(C)(2). A taxpayer regularly using the residence to provide day care for children, adults over age 65, or mentally or physically disabled persons may qualify for deductions allocable to the day care business. *See* § 280A(c)(4). Deductions under § 280A are limited to the excess of (1) gross income from the use of the dwelling unit over (2) the deductions allocable to the unit which are allowable without regard to business use. *See* § 280A(c)(5).

"principal place of business" is the most difficult, and the various tests which have been formulated by the courts cannot achieve equitable results.

Supreme Court Restrictions Are Not Reasonable

In *Soliman v. Commissioner*,5/ the Supreme Court exacerbated the statute's already confusing scheme. In that case, the Court attempted to address the appropriate factors a taxpayer must use in determining whether a home office is his or her "principal place of business." The taxpayer in *Soliman* was an anesthesiologist who was employed by three hospitals, but who maintained a home office as a principal place of business used exclusively two to three hours a day for contacting patients and surgeons, and for performing related activities.

Even though the hospitals provided no office space to the taxpayer in *Soliman*, the Supreme Court reversed the lower court decisions which had allowed the deduction.6/ The Court's effort significantly narrowed the scope of the home office deduction by setting up a comparative test for determining whether an individual's home office is that person's principal place of business.7/

The comparative test does not work. The Court's two primary factors -- (1) the relative importance of the activities performed at each business location, and (2) the amount of time the taxpayer spends at each place of business -- are too vague.8/

The IRS' subsequent explanation of how it will apply the "relative importance" and "time" tests highlights the complex problems that the normal, unsophisticated home office worker must now confront.9/ Under this ruling, the Service said it will first apply the "relative importance" test, and if this test yields no definitive answer, it will look to the "time" test.10/ There is no way for a home office worker to achieve any level of comfort with these rules without expending considerable funds in lawyer or accountant fees.

5/ 113 S. Ct. 701 (1993).

6/ 113 S. Ct. at 708.

7/ Id. at 706. The Court rejected both the "focal point" test formerly favored by the Tax Court and the facts and circumstances test subsequently adopted by the Tax Court, which had won approval of the U.S. Court of Appeals for the Fourth Circuit.

8/ Id. In denying the home office deduction, the Supreme Court determined that the taxpayer's treatment of patients at the three hospitals was the "essence of a professional service" and the "most significant event in the professional transaction." The home office activities were regarded as less important to the taxpayer's business than his work at the hospitals. Id. at 708.

9/ Rev. Rul. 94-24, 1994-15 I.R.B. 5. The IRS had previously announced that it will not challenge home office deductions taken for 1991 and earlier tax years if the taxpayer reasonably fell within the scope of previous guidance issued by the IRS. See Notice 93-12, 1993-8 I.R.B. 1. The Service has also withdrawn a portion of proposed regulations under § 280A (issued in 1983) to reflect the *Soliman* decision. See IA-23-93, 59 Fed. Reg. 26466 (May 20, 1994).

10/ Rev. Rul. 94-24, 1994-15 I.R.B. 5.

Responses to *Soliman*

We applaud Congress' response to the *Soliman* decision, as numerous bills were introduced in the 103rd Congress. In particular, we strongly supported the Home Office Deduction Act of 1994, introduced in the House by former Representative Hoagland (D-NE) (H.R. 3407) and in the Senate by Senator Hatch (R-UT) (S. 1924).11/ The bill would have provided that a home office can qualify as a principal place of business if "the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer," and the office is necessary because the taxpayer has no other location for the performance of such activities. The bill also contained a provision allowing for the deduction of business expenses attributable to home storage space for product samples. Currently, tax code section 280A(c)(2) allows a deduction for storage space for inventory only.

We were extremely pleased to see that Chairman Archer included the provisions of the Home Office Deduction Act in sections 12003 and 12004 of the Job Creation and Wage Enhancement Act of 1995 (H.R. 9), introduced on January 4. We urge their inclusion in the first tax bill which the Congress sends to the President this year.

Clarifying Home Office Expense Deduction Makes Sense for the 1990s and Beyond

The *Soliman* decision is not in step with commercial practice and economic reality. Home-based businesses have been growing in number and will likely continue to do so for the indefinite future.12/ These businesses create opportunity and jobs.

Many individuals affected by corporate downsizing have responded by creating small businesses operated out of the home. With the advent of fax machines, personal computers, and other telecommunications advances, these entrepreneurs have been able to run businesses out of the home that traditionally required an office setting. The success of many of these businesses has depended on whether or not they could be started up as home-based enterprises. The existence of a tax deduction for home office expenses can make an important difference for these fledgling companies.

Clarifying the home office expense deduction also makes sense from a family perspective. Home-based businesses have become an attractive option for parents who choose to work at home to spend more time with their children or elderly parents. Taxpayers should not be penalized for making such a choice.

Background on Self-Employed Health Insurance Tax Deduction

We also strongly support enactment of legislation allowing self-employed individuals to deduct their health insurance costs.

11/ H.R. 3407 had 83 cosponsors (37 Democrats/46 Republicans), including 13 Members of the Ways and Means Committee. S. 1924 had 15 cosponsors (7 Democrats/8 Republicans), including 3 Members of the Finance Committee.

12/ One 1992 news article reported that approximately 30 million Americans work out of the home. See G. Hall, Home Based Businesses Create Local Controversies, Gannett News Service (Nov. 10, 1992); see also New Publishers Serve At-Home Workers, L.A. Times, Feb. 14, 1993, at D10. The number of publications serving the growing number of at-home workers has risen dramatically. At present, there are approximately 50 publications. See id.

Prior to January 1, 1994, a self-employed individual generally could deduct 25 percent of the amount paid for health insurance for the taxable year on behalf of the individual and his or her spouse and dependents.13/ Congress' purpose in establishing this deduction in 1986 still exists today. At that time, lawmakers expressed concern about the disparity in tax treatment of health benefits between self-employed individuals and owners/employees of incorporated businesses.14/ The 25 percent deduction that self-employed individuals received for their health insurance premiums was designed to provide at least some portion of the favorable treatment for health insurance afforded employees covered under an employer-provided plan.15/

Restoring Self-Employed Deduction Would Represent Strong Step Toward Providing Equitable Treatment to Home Office Businesses

Mr. Chairman, a sense of excitement exists when entrepreneurs start up their home office businesses. Many express relief to be free from headaches like commuting, endless meetings, and office politics. They feel that they will be as free to go as far as their abilities will take them. Then, reality sets in. They realize that they often have to pay more for everything. For starters, they realize that they have to buy their own health insurance coverage at outrageous costs, and that the Federal Government, by providing disparate treatment with respect to health care expenses, caters to big business, not to them.

HOAA believes it is unfair and unjustified to premise the availability of a tax benefit on whether a taxpayer works for a Fortune 500, Subchapter C corporation or for himself or herself in an unincorporated business. Such treatment is simply one example of the ways home office businesses operated by self-employed individuals are treated as second-class businesses. Retroactively restoring the 25 percent deduction for self employed persons would represent a strong first step toward providing more equitable treatment to home office businesses. We urge you to do so prior to the April 15 filing deadline for individual tax returns. We also hope that lawmakers will ultimately enact legislation providing a 100 percent deduction for the health care costs of self-employed individuals, as has been proposed by numerous lawmakers and the Clinton Administration.

Conclusion

To conclude, I appreciate the opportunity to submit testimony on the importance to HOAA of preserving the home office expense deduction and reinstating the health insurance tax deduction for

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13/ This provision expired on December 31, 1993. See § 162(l). Sole proprietors, working partners in a partnership, and S corporation employees who own more than two percent of the corporation's stock could take advantage of the deduction. See Senate Committee on the Budget, Tax Expenditures: Compendium of Background Materials on Individual Provisions, S. Prt. 101, 103rd Cong., 2d Sess. 425 (1994) ["Tax Expenditures"].

14/ Tax Expenditures, supra note 13, at 428. An employer's contribution to a plan providing accident or health coverage to an employee and the employee's spouse and dependents is excludable from an employee's income. Further, businesses can generally deduct as an employee compensation expense the full cost of health insurance coverage provided to employees. See Joint Committee on Taxation, Summary of Revenue Provisions in the President's Budget Proposal for Fiscal Year 1993, JCS-3-92 46 (Feb. 6, 1992).

15/ Tax Expenditures, supra note 13, at 428.

self-employed workers. The *Soliman* decision is ill-suited to the modern economy. Clarification of the home office expense deduction rules makes sense from both a business and family perspective. Further, extending the health insurance tax deduction for self-employed workers will at least begin the process of equalizing the treatment of self-employed workers and those who work for Subchapter C corporations.

STATEMENT OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman, Members of the Committee: The Independent Bankers Association of America (IBAA) appreciates the opportunity to express its views on two matters of long-standing interest to our membership, savings incentives and the estate and gift tax laws that are now before the Committee.

IBAA is the only national trade association that exclusively represents the interests of the nation's community banks.

IBAA SUPPORTS ENHANCED SAVINGS INCENTIVES

For the past several years, IBAA has expressed its support of tax incentives for savings in resolutions approved by our entire membership. These resolutions specifically endorse expanding existing Individual Retirement Accounts (IRAs) as well as the establishment of other tax-advantaged savings products.

IBAA very much appreciates the opportunity to present its views to the Ways and Means Committee at this time, because the subject is of special significance to community banks. IBAA commends the Chairman (Mr. Archer) and the Committee on the prompt scheduling of these hearings. IBAA also commends the new House Leadership for making the encouragement of savings a national priority issue in 1995. We also commend the Administration for its proposal to expand the income limits on existing IRA accounts.

Our statement addresses the issues we believe are involved.

NEED FOR SAVINGS INCENTIVES

IBAA feels it is not an exaggeration to say that the U.S. is experiencing a "quiet crisis" of inadequate savings and investment.

Federal Reserve Chairman Greenspan said as much to this Committee in a 1991 hearing on tax policy: "the national balance sheet has been severely stretched" by large accumulations of debt in the 1980s by corporations (for mergers and buyouts), by real estate firms (for development of offices and other commercial space), and by consumers (for motor vehicles and other durables). The aftermath, Greenspan said, "is a considerable degree of financial stress . ." (Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, December 18, 1991).

The Chairman's principal recommendation was as follows:

> "I and others have long argued before this Committee that the essential shortcoming of this economy is the lack of savings and investment. It's here that our major policy focus should rest. Investment is the key to enhanced productivity and higher living standards. . . Bolstering the supply of savings available to support productive investment must be a priority for fiscal policy (Loc. cit., pages 6-7).

From the standpoint of both national and personal saving, the situation seems to have gone from bad to worse since Chairman Greenspan's appearance.

The nation's largest securities firm reported that, during 1992, America's net national savings rate -- the sum of savings by governments, businesses and individuals -- fell to 1.7 percent, the lowest level since World War II ("National Saving: Key to Investing in the Future," Merrill Lynch Pierce Fenner & Smith, Inc., 1993, page 1). This 1.7 percent figure is consistent with a tabulation by the Organization for European Development and Cooperation, showing U.S. net national savings, as a percentage of Gross Domestic Product, was even lower in 1993 -- 1.2 percent ("OECD IN FIGURES," Statistics on the Member Countries, Supplement to the OECD Observer No. 188, June/July 1994).

The U.S. net national savings rate is thus smaller than all but five of the 24 industrialized members of the OECD. By comparison, the 1993 savings rates for other countries with which the U.S. must compete, were: Belgium 11.5%, France 6.5%, Germany 9.8%, Japan 19.5%, Switzerland 19.3%, Turkey 10.2% and the United Kingdom 2.0% (OECD, loc. cit., pages 24-25).

For personal savings, the story is similarly dismal. From the 1960s to the mid-1980s, personal savings in the U.S. cycled between 6 and 9 percent. However, in the seven years between 1987 and 1993, the average personal savings rate declined to 4.6 percent. Then, in the 12 month period ending in August, 1994, the rate fell to 3.8 percent, the lowest level in U.S. history (see "Americans Run Out of Options to Boost Their Spending," by John Berry, Washington Post, October 20, 1994, page B13). A table comparing U.S. personal savings rates with those of other OECD nations since 1977 is attached as Exhibit 1.

As an economist, before becoming Treasury Undersecretary for International Affairs, Lawrence H. Summers concluded that reductions in U.S. personal savings during the 1980s accounted for more than twice the decrease in national savings than did the increase in government deficits ("Savings: The Hidden National Crisis," Merrill Lynch, Inc., 1992, page 5).

This shortage in savings means there is less money available for investment in long-term municipal and other bonds to fund improvements in the U.S. infrastructure.

The deterioration of or national infrastructure has been a matter of increasing concern for a decade. As to just one segment, the 3.9 million mile U.S. highway system: the Department of Transportation (DOT) estimates that half the nation's roads are substandard and, of the 573,660 bridges more than 20 feet long, 1/3 are in substandard condition and about 1/5 are functionally obsolete. The DOT Road Information Program estimates that the cost of additional fuel and vehicle wear and tear resulting from these conditions is about $17.5 billion annually (White Paper, American Road and Transportation Builders Association, Dec. 16, 1994). DOT's report on "The Status of the Nation's Highways, Bridges and Transit" estimates a $290 billion backlog of needed but unfunded road and bridge projects. Increased savings would make it possible to address vital highway, bridge, transit and air travel problems.

One observer estimated that half of U.S. domestic investment in the 1980s was financed with foreign capital ("Savings: The Hidden National Crisis," Merrill Lynch etc., loc. cit., page 2).
This is not a healthy situation.

A growing literature documents the inadequacy of household savings, especially for retirement. According to Merrill Lynch, the ratio of household assets to household debt has dropped from 20:1 in the 1940s to about 5:1 in 1993 ("National Saving: Key to Investment in the Future," Merrill Lynch, loc. cit., 1993, page 3).

One study, commissioned by Merrill Lynch found that families headed by individuals less than 45 years old had median net financial assets of only $700, while families headed by individuals in the 55-64 age bracket (e.g. approaching retirement), had median net financial assets of $6,880, and families headed by individuals aged 65-74 had median net assets of $10,000. Merrill Lynch states that the results of this current study, based on 1991-93 data, is "virtually unchanged" from a similar analysis based on 1987 data ("New Data Shows Wealth of American Families at 'Woeful Low'," Merrill Lynch & Co., Inc. press release, December 21, 1994). A table from this study is attached as Exhibit 2.

Merrill Lynch also commissioned a study of the savings habits of 2,015 households representative of the 76 million "baby boomers," who will live longer than their parents. The survey found, that under current fiscal assumptions, these households are saving at a rate of 35.9 percent of what would be required to enjoy a retirement "consistent" with their current lifestyles ("The Merrill Lynch Baby Boom Retirement Index," 1994, page 1).

IBAA's conclusion from this information is that there would be manifold benefits from encouraging personal savings. Initially, increased personal savings prepare families better for major expenditures, such as home and car buying, college and retirement, as well as medical and other emergencies.

Such savings increase the capacity of financial institutions to fund the debt of governments and corporations through domestic resources, rather than foreign capital, to upgrade America's infrastructure through investment in municipal bonds, to build productive capacity of corporations through investment in corporate bonds and stocks, and to enhance job creation and innovation through loans to small enterprise. The combination of these results would enhance the performance and competitiveness of the U.S. economy all along the line.

BENEFITS TO COMMUNITY BANKS OF SAVINGS INCENTIVES

Smaller, independent community banks have a real stake in the possible enhancement of savings incentives, because community banks rely for their funding almost exclusively upon domestic deposits (96.5 percent). Larger banks, with multiple sources of funds, rely far less on domestic deposits (68.4 percent), as shown in the following table:

Relative Importance of Domestic Deposits
To U.S. Banks of Different Sizes

	Less than $100 million	$100 million to $1 billion	$1-10 billion	Greater than $10 billion
Total assets:	$320.3	$687.7	$1,087.6	$1,836.7
Deposits:	278.3	569.7	776.6	1,168.6
Assets less equity: (Liabilities)	288.3	620.0	997.5	7,707.8
Deposits as percentage of Liabilities:	96.53	91.89	77.85	68.43

Accordingly, increased savings incentives could be even more valuable to smaller banks and their customers than to larger banks.

This value of dedicated savings to independent banks is confirmed by the following figures on the distribution of IRA and Keogh Plans, which indicates that the value of these savings plans in community banks (about 10.7 percent) is slightly higher than their share of overall deposits (about 9.96 percent).

IRA & KEOGH PLANS*				
	# of Banks	Totals for IRAs & Keogh	Average per Bank	Median Amount
< 100M	7,412	15,519,659,000	2,093.855	1,647
100M-1B	2,791	35,002,962,000	12,541.369	9,284
1B-10B	335	46,060,219,000	137,493.191	121,185
> 10B	57	47,863,851,000	839,716.684	911,258

Data as of 9/30/94, One-Source, Sheshunoff Information Service, 1st quarter 1995

BENEFITS TO SMALL BUSINESSES

Small enterprise is one of the most important elements of U.S. economic life. According to the Small Business Administration (SBA), small businesses account for 53-55 percent of U.S. sales and 52-53 percent of U.S. jobs.

However, of great significance in an era of large-corporate downsizing and large-bank consolidations, is the SBA finding that, between 1976 and 1990, small businesses (500 employees or less) accounted for nearly 2/3 of the net new jobs in our economy (65 percent). Small independent businesses are often the anchors of towns and communities across the country, and are therefore a tangible factor in the quality of American life. And, small business lending is the bread and butter of community banking.

A study of the 1993 Federal Reserve Call Report data by Robert Morris and Associates illustrates how strongly small banks support small businesses. Banks with less than $100 million in assets, which would have up to 50 employees, rank, generally, as community banks. These institutions appear to make more than a quarter of all small business loans of less than $100,000 (28.17 percent, or $21.8 billion out of a total of $77.4 billion). The $21.8 billion amount of these loans by the smallest banks exceeds the total amount of such loans by any category of banks. ("Credit Availability for Small Businesses," The Journal of Commercial Lending, April, 1994, page 51).

Banks with under $100 million in assets thus concentrate on small business lending. Almost 3/4 of all their commercial and industrial loans (73.65) are of less than $100,000. Banks with assets of $100 million to $300 million make about half of their loans in amounts of less than $100,000 ($17.7 billion out of $34.2 billion, or 51.75 percent). The largest banks (over $5 billion in assets) made $17.6 billion or 6.73 percent of their loans in amounts of under $100,000

There is also evidence to suggest that megabanks, that intensely compete with other megabanks, are increasingly shying away from small business lending, where margins are slimmer, or resorting to formula-based decision on small business loans which inhibits the diversity and creativity of small business enterprise ("Is it Banking Without Boundaries or Megabanks Without Constraints? by Kenneth A. Guenther, Executive Vice President, IBAA, Washington Post, January 17, 1995).

Thus, an increased flow of funds into IRA-type retirement vehicles, or similarly structured savings accounts, is very likely to generate a significant additional "bang for the buck" in terms of financing for job-creating, innovative, revenue producing small independent businesses.

LEGISLATIVE ISSUES INVOLVED WITH SAVINGS INCENTIVES

The legislative history of IRAs indicates that there have been a variety of policy approaches to savings tax incentives over the years.

When IRAs were created in 1974, as a part of the Employment Retirement Income Security Act (ERISA), they were designed as a retirement savings vehicle for employees not otherwise covered by a pension plan. The Tax Reform Act of 1981 made all workers eligible for IRA deductions of up to $2,000 per year (a so-called 'universal' approach). The Tax Reform of 1986 than restricted IRA eligibility to single taxpayers with incomes of less than $25,000 and married taxpayer couples with incomes of less than $40,000, on condition that these taxpayers were not covered by pension plans.

In recent Congresses, Senator Lloyd Bentsen, prior to his tenure as Treasury Secretary, collaborated with Senator William Roth to introduce a 'Super-IRA' bill, which proposed to restore universal eligibility and provide options of either the tax deductible contribution of existing IRAs or a 'back loaded' alternative that would be funded with after-tax money, but could be removed tax free after age 59 1/2. Another proposal by Senator Kay Bailey Hutchison, S. 1669 of the 103rd Congress, was to permit a tax-deductible contribution by a non-working spouse. IBAA supported these proposals.

The Contract With America proposed:

- to restore universal eligibility,
- to permit a $2,000 (single taxpayer) or $4,000 (joint return) contribution,
- to have this contribution non-deductible, but to allow withdrawal for retirement and, after a prescribed period, for other specified purposes such purchase of a first home (owner occupied), education (college or above), or medical expenses, including insurance for long-term care. The Contract measure was introduced in the 104th Congress as the American Dream Savings Act on January 4, 1995 (H.R. 6). A more detailed bill is being authored by Rep. Bill Thomas of California.

In the Senate, also on January 4, 1995, Senators Roth and Breaux introduced S. 12, the Savings and Investment Incentives Act of 1995. This bill proposes 'front-loaded' deductions that index the current $2000/$4000 limits to the rate of inflation after 1995. The income eligibility would be expanded from the present $25,000 for single taxpayers, to $125,000 by 1998; and for joint return taxpayers, from the present $80,000 to $140,000 by 1998. This measure would also permit a 'homemakers' deduction of up to $2,000, but limited to the amount of compensation earned by a spouse.

Consistent with past years, the Senate bill also provides an option of an 'IRA-Plus' Account that would be subject to the same contribution and eligibility limits. These sums would not be tax deductible at the outset, but the earnings would be tax free and the proceeds could be withdrawn after five years penalty free to purchase a first home, pay higher education expenses, or defray catastrophic medical expenses.

Also part of the picture is the President's proposal to double the income limitations of the existing IRS program, to $50,000 for single taxpayers and $80,000 for joint return taxpayers.

EVALUATION OF PROPOSALS

After its preliminary review of the various proposals, IBAA has several comments. However, the association also wants its pertinent banker committees to review these matters, so that we provide detailed comments.

On the basis of its on-going study of these issues, IBAA can observe that tax incentives for saving are a 'going concern.' They are familiar to many Americans and most financial institutions. IRA accounts are currently found at 10,655 commercial banks, more than 2/3 of which (69.6 percent) are community banks with assets of less than $100 million. These numbers testify to the fact that IRA-type saving is well established in this country and that an expansion of such a program would be accomplished speedily and with few administrative problems.

IRAs at banks are insured, to $100,000, by the federal government, so there is no question of safety and soundness of future IRA-type investments in a banking environment.

Thus, an expansion of tax incentives for saving, particularly bank based savings, is a matter of utilizing an existing, proven system. The additional savings that flow into that system will help those who save, the institutions that receive the funds (especially community banks), the customers of those institutions (including prominently, in the case of banks, small business enterprise), and the national economy.

At present there is considerable debate on how much of funds devoted to tax-advantaged accounts is new savings and how much is transferred from elsewhere. For example, see "The Coming Changes in IRA's Will Be Popular, But They Won't Make American's Save More" Barron's Magazine, January 16, 1995. Barrons' conclusion is based on the work of a National Bureau of Economic Research study by Attanasio and DeLeire. However, the NBER study has been criticized as incorrect on the law, facts, and interpretation by a study performed for the Securities Industry Association by Hubbard and Skinner. The SIA study concludes that raising the IRA contribution limit would increase the nation's capital stock by $4 for each dollar lost in government tax revenue ("The Effectiveness of Savings Incentives: A Review of the Evidence," Hubbard and Skinner, January 19, 1995, Executive Summary).

IBAA finds desirable features in all of the current proposals, and believes any tax incentive legislation passed by this Congress could provide that questions of effectiveness and the structure of the tax-advantaged savings be studied with care, so future decisions would be informed by such analysis. Because savings tend to be a long-term matter, this area of policy seems to be susceptible to such a studied approach.

IBAA thus has no hesitation in urging that the Ways and Means Committee and the House of Representatives move forward with the maximum limits and flexibility for savers that is consistent with budget constraints.

IBAA will be delighted to work with the Committee on Ways and Means and the House of Representatives to resolve outstanding issues as the American Dream Savings proposal works its way through the legislative process.

THE IMPACT OF ESTATE TAXES ON BUSINESS ENTERPRISE

According to the briefing papers for the White House Conference on Small Business, about 30 percent of businesses are passed down to a second generation and only 13 percent reach a third generation. Although there many reasons for this, federal estate and gift taxes are significant barriers to succession of ownership of smaller business.

Community bankers are affected directly and indirectly. Many banks are multigenerational enterprises, founded when land and structures were inexpensive. As branch locations have been added to serve growing populations, and population growth has brought residential and commercial development to the doorsteps of community banks, the value of even very small family banks can go up dramatically.

An example is a one location, 8-employee family bank in central Kansas, with assets of $15 million. The bank was founded after World War II by the father of the current president and his mother-in-law. Both were tax conscious, and approximately $50,000 was spent over the years with various tax advisors and trust expenses. However, after the founding father died in 1988, his estate paid the federal government $700,000 in estate taxes.

Banks are also impacted if a business customer must pay a heavy estate tax. Bank loans and the very existence of the firm may be at risk. Communities suffer because steeply graduated estate tax rates, reaching 55 percent at $3 million in taxable estate, cause many long-standing businesses to liquidate to pay the tax bill, or sell out to a large and/or absentee business to avoid such taxes. The loss of independent business usually means that suppliers and service providers in a local community are phased out in favor of firms doing business with a parent company elsewhere.

IBAA commends the House Leadership and the Chair of the Ways and Means Committee for its attention to estate tax matters through the Contract With America and these hearings.

For almost a year, IBAA has been actively working to define current estate and gift problems in order to be able to recommend solutions addressed to these problems.

There has been very little recent legislative attention to the consequences of the major estate tax changes of 1976, 1981 and 1986. One article by the Internal Revenue Service, based on 1989-91 data, finds that during the past decade, the number of estate tax filers has increased by 80 percent and the total estate of these filers increased by 94 percent. The fact that the largest block of assets in these estates tends to be stock in closely-held (small) businesses and the fact that filers with assets of more than $5 million is the fastest growing element (increasing 137 percent since 1982) reflect the increasing scale of business enterprise in this country ("Estate Tax Returns, 1989-91" Statistics of Income, IRS, Summer, 1993, page 76).

The combination of a steep estate tax rate structure and major increases in cost-efficient scale of businesses spells estate tax trouble for America's closely-held community agricultural, commercial and financial businesses.

We applaud the proposal to increase the filing threshold from $600,000 to $750,000 in three stages that is contained in the Contract With America legislation (H.R. 9). Enactment of this provision would be an excellent first step, but it would not solve the fundamental problems with the current estate and gift tax structure, and the major economic problems of deterring investment and maintaining continuity of independent, job creating firms. A broader approach is needed.

In an effort to better define these problems, and to craft responsive solutions, the IBAA has contacted other associations, across the spectrum of American business, agriculture and finance to call for a common effort to improve the estate and gift tax laws.

IBAA had developed a questionnaire, which is presently in the hands of more than three dozen associations. This survey is designed to elicit current data on where problems are -- and where they are not -- and recommended solutions that fit various segments of the American small business community.

IBAA will be pleased to share the information we receive and our recommendations with the Committee and the House of Representatives as soon as possible.

Thank you again for this opportunity to express to the Committee our views on these important matters.

STATEMENT OF INVESTMENT COMPANY INSTITUTE BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES HEARING ON TAX PROVISIONS IN THE CONTRACT WITH AMERICA DESIGNED TO ENCOURAGE SAVINGS AND INVESTMENT

January 25, 1995

The Investment Company Institute respectfully submits this statement in connection with the Ways and Means Committee review of tax provisions in the Contract With America designed to encourage savings and investment. We applaud the Committee for considering legislative changes that would further these goals. In this statement, the Institute urges a few modifications to the provisions in H.R. 9 (the "Job Creation and Wage Enhancement Act of 1995") that would increase or "index" the cost basis of capital assets for inflation.

I. Introduction

The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,510 open-end investment companies ("mutual funds"), 471 closed-end investment companies and 12 sponsors of unit investment trusts. Its mutual fund members have assets of about $2.099 trillion, accounting for approximately 95 percent of total industry assets, and have over 38 million individual shareholders. The vast majority of open-end and closed-end investment companies are organized as regulated investment companies ("RICs").

The Institute submits that the Committee should take two principles into account when applying to RICs and their shareholders any proposal to index cost basis for inflation. First, any such legislation should follow the model of Subchapter M of the Internal Revenue Code and provide RIC investors with tax treatment comparable to that provided to direct investors in securities. Second, any legislation should be drafted to minimize the complexities that indexing would create for RIC shareholders.

We commend Chairman Archer for including in H.R. 9 indexing provisions that are generally consistent with the principles that we submit should apply to RICs and their shareholders. In addition, we are pleased that H.R. 9 resolves several implementation issues that would have arisen for RICs and their shareholders under bills considered in 1989 and 1992. Our comments today focus on a few technical issues that indexing would present for RIC shareholders and other investors.

II. Indexing Provisions in H.R. 9

H.R. 9, like earlier indexing bills, would index both portfolio securities held by RICs and RIC shares held by investors. Indexing a RIC's portfolio securities protects RIC shareholders from paying tax on inflationary gains realized by the RIC that otherwise would be distributed to shareholders as capital gain dividends. Indexing the basis of RIC shares protects RIC shareholders from paying tax on inflationary gains in the value of their RIC shares when those shares are redeemed.

Under the bill, RIC shares would be treated as an indexed asset for any calendar month in the same ratio as the value of the RIC's assets at month-end which are indexed assets bears to the value of all of the RIC's assets at month-end (the "indexed asset calculation"). For example, if 82 percent of a RIC's assets were indexed assets on January 31, that RIC's shares would be eligible for 82 percent of any inflation adjustment allocated to that month. Safe harbors in the bill provide that if (a) 90 percent or more of the RIC's assets were indexed assets for any month, the RIC would be deemed to be fully (100 percent) invested in indexed assets for that month, and (b) 10 percent or less of the RIC's assets were indexed assets for any month, the ratio for that month would be zero.

III. Indexing Issues for RIC Shareholders

A. The 90 Percent Safe Harbor

1. Issue

Institute data indicates that most RICs do not consistently invest at least 90 percent of their assets in equities.[1] Since most RICs would not, therefore, always meet the bill's 90 percent safe harbor, most RIC shareholders would not be able to fully index the cost of their shares. Thus, instead of using an inflation adjustment chart prepared by the IRS (that would show the appropriate adjustment for assets purchased and sold in specified quarters), RIC shareholders would be required to use a specialized chart, applicable to only one RIC, that reduced the otherwise applicable indexing adjustment to reflect the actual ratio of indexed assets in that RIC's portfolio. Any RIC shareholder or tax return preparer who used (a) the official government chart when the RIC had not always met the safe harbor or (b) a RIC-specific chart for any other RIC would improperly compute indexed cost basis.

2. Proposal

The ease with which indexing could be applied to RIC shares would be enhanced if the safe harbor were modified so that (a) determinations of the extent to which RIC stock would be treated as an indexed asset were made quarterly rather than monthly and (b) the safe harbor provision treated the ratio of indexed assets to all assets as being (i) 100 percent if 80 percent or more of the RIC's portfolio is in indexed assets, and (ii) zero if 20 percent or less of the RIC's portfolio is in indexed assets. Our data for the eleven quarters ending with the second quarter of 1994 indicates that 49 percent of all equity funds would have met our proposed safe harbor, whereas only 14 percent of all equity funds would have satisfied a 90 percent safe harbor tested quarterly.[2]

B. Return of Capital

1. Issue

One basis adjustment that could effect the calculation of indexed cost basis would be the distribution by a RIC of more than its taxable income (i.e., a return of capital). Returns of capital are more common for RICs than other corporations because RICs are subject to such stringent requirements on the current distribution of their income that very small errors in estimating or calculating income can result in overdistributions. If a RIC returned capital to its shareholders, the shareholders would be required under the bill to (a) index each block of shares for inflation occurring through the date the capital is returned, (b) reduce the cost basis of each block by its proportionate share of the amount of capital returned and (c) thereafter adjust this modified basis for any future inflation.

2. Proposal

Rather than requiring that all blocks of RIC shares be adjusted up for inflation and then down for a return of capital, we urge that the basis of RIC shares be adjusted when capital is returned on a first-in, first-out basis. To illustrate our proposal, assume that (1) a shareholder purchases RIC shares for $1,000 in each of ten years; (2) inflation totals 40

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[1] Institute statistical reports indicate that the 90 percent safe harbor test would have been satisfied on a quarterly basis (for the 11 quarters ending June 30, 1994) by only 14 percent of the 423 equity funds that provided the ICI with portfolio composition data for all 11 quarters. For these purposes, a fund is described as an equity fund if its stated investment objective (a) is to invest at least 65 percent of its assets in equities or (b) clearly indicates that it will invest principally in equity securities. Our data indicates that the percentage of funds satisfying the safe harbor drops significantly further when other funds that hold equity securities, such as "balanced funds" holding both stocks and bonds, are included in the data pool.

[2] Presumably, even fewer of these funds could meet H.R. 9's safe harbor, which tests portfolio composition on a monthly, rather than a quarterly, basis.

percent from the date of the first purchase; and (3) the shareholder receives a $100 return of capital. Under our proposal, the investor would index the basis in the first block of shares from $1,000 to $1,400 (to reflect 40 percent inflation) and then reduce this basis $100, to $1,300, for the return of capital. By adjusting only the first block, the investor has eliminated 90 percent of the computations that would be required under the bill (since only one of his blocks would be adjusted under our proposal).

C. Retained Capital Gains

1. Issue

Similar basis adjustments appear to be required under the bill if a RIC retains capital gains and pays a RIC-level tax. Pursuant to Code section 852(b)(3)(D), a shareholder in a RIC that retains capital gains includes in income his share of the retained gain, claims a tax credit corresponding to the tax paid by the RIC on the retained gain, and increases the cost basis of his shares by the remaining balance.

Under the bill, taxpayers holding stock of a corporation are to treat any "substantial contribution to capital" as a separate asset. It appears that this rule would apply to a RIC's retained capital gain by requiring the RIC's shareholders to index each block of shares for inflation through the date the gain was retained, proportionately increase the cost basis of each block of shares to reflect the retained gain and thereafter adjust these increased amounts for any future inflation.

2. Proposal

The Institute urges that the bill be modified to apply the substantial contribution to capital rule only to the first block of RIC shares acquired by an investor. Thus, if an investor's first block of RIC shares were purchased for $1,000, inflation had been 40 percent, and the full amount of the investor's basis adjustment under Code section 852(b)(3)(D) were $65, the investor would index the basis of these shares from $1,000 to $1,400 and then add the full $65 contribution to capital to these shares, thereby increasing the basis to $1,465. This approach would be simpler than indexing the cost basis of each block of shares and then spreading the $65 contribution to capital across all of the blocks of shares.

IV. Indexing Issues for RIC Shareholders and Other Investors

A. Calculating Inflation Using Prior Quarter Deflators

1. Issue

Under H.R. 9, inflation adjustments would be calculated by comparing the "first revised" Gross Domestic Product ("GDP") deflator for the quarter in which an indexed asset is disposed of with the "first revised" GDP deflator for the quarter in which the asset was acquired. Currently, this "first revision" is not available until approximately two months following the close of the quarter. In the case of RIC share redemptions occurring during October, November and December, for example, the GDP deflator number that investors would need to calculate inflation adjustments would not be available until approximately March 1 of the next calendar year (or a mere six weeks before their April 15 tax return filing deadline). Similarly, with respect to October dispositions of RIC portfolio securities, the GDP deflator number would not be available until after the RIC was required, by the Code section 4982 minimum distribution excise tax rules, to calculate and distribute these capital gains.

2. Proposal

These difficulties could be eliminated if the inflation adjustment were calculated using the GDP deflators for the quarter prior to the quarter of purchase and the quarter prior to the quarter of disposition. The practical effect of this modification would be to credit an investor with inflation occurring during the quarter of purchase, but not with inflation occurring during the quarter of sale. The obvious benefit of this modification is that the inflation factor for all fourth quarter dispositions would be known in late November or early December of that quarter.

B. Indexing For Partnerships

1. Overview

The investment company industry is also interested in how indexing would apply to investments in partnerships. The principle reason for this interest is that some investment companies have recently begun to invest substantially all of their assets in a single investment pool that in turn performs the portfolio management function for its investors. In this so-called "master-feeder" structure, the "master fund" is usually structured as a trust and is classified for federal tax purposes as a partnership. Its partners (the "feeder funds") typically qualify as RICs. The master fund, as well as its RIC feeders, are registered as open-end investment companies under the Investment Company Act of 1940.

Under current law, a RIC investor effectively is in the same tax position whether his RIC purchases securities directly or instead purchases them indirectly through a master fund. Under H.R. 9, the same indexing benefit should be available whether the shareholder's RIC holds securities directly or holds them indirectly through a master fund.

2. Issue

The only provision in H.R. 9 dealing with indexing for partnerships is new Code section 1022(f)(1), which provides that indexing adjustments made at the partnership level would be passed through to the partners. The bill provides no other mechanism for a partner to adjust the basis of his partnership interest for inflation. In contrast, earlier indexing bills provided that a partner's basis in a partnership that held indexed assets would be adjusted when the partner transferred the interest if the partnership had made an election under Code section 754.

3. Proposals

For indexing to work properly for investors whose RICs invest substantially all of their assets in a master fund, a RIC partner that withdraws from a master fund partnership should be permitted to index its basis in the partnership in order to reflect the effects of inflation on the indexed assets held by the partnership. This adjustment could be dependent upon whether the partnership had made an election under Code section 754 (or perhaps a new election tied specifically to indexing).

Similarly, a master fund should be permitted to periodically (e.g., quarterly) adjust its basis in its indexed assets (as if the partnership had made a disposition of the assets at the time of the periodic adjustment). This would permit a corresponding adjustment to each feeder fund's basis in its partnership interest, which is important for purposes of properly determining the effect of cash distributions on a partner's basis. Such distributions will occur, for example, when a feeder fund needs cash to meet redemptions of its shares.

V. Conclusion

The Institute urges consideration of these modifications needed for regulated investment companies and their over 38 million individual shareholders. We would be pleased to discuss these issues further with the staff of the Committee.

Statement by the

National Association of Real Estate Investment Trusts®

to the

House Ways and Means Committee

regarding the Hearing on

The Job Creation and Wage Enhancement Act of 1995

Submitted by Mark O. Decker, President and CEO

January 26, 1995

We appreciate the opportunity to comment on the capital formation provisions of the Job Creation and Wage Enhancement Act of 1995. The National Association of Real Estate Investment Trusts® ("NAREIT") represents over 240 real estate investment trusts (known as "REITs"), about 200 of which trade on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ. In addition, NAREIT represents over 1,600 lawyers, accountants, analysts, investment bankers, and others who provide services to the REIT industry.

Congress established REITs in 1960 to allow small investors to obtain the diversification and professional management of real estate that beforehand were only available to large, sophisticated investors. Capital formation has been essential to the growth and success of REITs ever since, and the promise of a large scale, widely held real estate capital market has begun to become a reality. The market capitalization of publicly held REITs has blossomed from under $9 billion at the beginning of 1991 to about $45 billion today. This success story is due in large part to the tax modernization reforms adopted by Congress over the years, as advocated by you, Mr. Chairman, and others on this Committee.

The maturation of the REIT industry would not have been possible without capital formation. Thus, NAREIT applauds the intent of H.R. 9 to create further incentives for the public to invest in the stock market. Specifically, NAREIT wholeheartedly endorses the proposal to reward the entrepreneurial risks of investing in stock by reducing the capital gains tax.

In addition, NAREIT supports the intent of H.R. 9 to index the tax basis of investors' stock to avoid taxing the noneconomic increase of value attributable to inflation. However, there appears to be some provisions in H.R. 9 that could deny such indexing to investors in REIT stock. Such a result would be terrible for the REIT industry because investors would have an incentive to invest in other companies for which they could receive the benefits of indexation.

H.R. 9 would allow stock in a REIT to be fully indexed only if 90% of the REIT's assets are "indexed assets," that is, corporate stock or tangible property. I will briefly summarize the three major technical provisions in H.R. 9 that could disqualify REIT shares from full indexation.

First, H.R. 9 excludes as an "indexed asset" any "net lease property." The nature of the real estate business is such that this definition could easily prevent more than half of today's REITs from qualifying for indexation. For example, many of our shopping center, health care, industrial, hotel, and net lease REITs own and operate portfolios of properties that fall under the net lease definition in H.R. 9. These REITs are in the ongoing real estate business and are completely different from the single shot, financing vehicles that the original net lease definition was meant to encompass.

Second, many REIT investments are made through partnerships. However, H.R. 9 could be interpreted to exclude as "indexed assets" properties held through a partnership. Such an interpretation would be contrary to the tax Code's usual rule of treating a partnership as an aggregation of the partners rather than as a separate entity.

Third, the 90/10 safe harbor is a good idea because the administrative complexity of requiring REIT shareholders to adjust only a portion of their tax basis is not justified when most of the REIT's assets qualify as indexed assets. However, we recommend that the 90% threshold be reduced to provide REITs with greater flexibility in conformity with the REIT asset tests.

NAREIT urges the Committee to enact these capital formation incentives after making our suggested technical changes to allow REITs to raise capital on an even playing field. Thank you once again for the opportunity to comment on this important legislation.

NATIONAL ASSOCIATION OF STATE FORESTERS

444 North Capitol Street, NW Suite 540 Washington, D.C. 20001 202/624-5415

February 3, 1995

The Honorable Bill Archer
Chairman, Committee on Ways & Means
1102 Longworth House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I am writing to add the voice of the National Association of State Foresters to the forestry experts who supported the capital gains tax revisions being considered by your committee on January 25. As public officials who work with this Nation's nearly 8 million non-industrial private forest landowners, we firmly believe that more equitable tax treatment will provide a major incentive for quality, long-term management of these lands, and will benefit both the economy and the environment.

The National Association of State Foresters represents the directors of the State forestry agencies from the fifty States and four U.S. Territories (American Samoa, Guam, Puerto Rico and the U.S. Virgin Islands), as well as the District of Columbia. Our members provide management and protection services on State and private forest lands, which make up over two thirds of the Nation's forests.

Taxes play a major role in landowner's decisions about the management of their lands. The 1986 revisions to the tax code imposed a harsh new tax burden on timberland owners, and is unintentionally providing a disincentive to sound forest management. The changes increased capital gains taxes on timber sales, and in some cases caused individual timberland owner's state taxes to jump as well. In addition, since landowners are no longer able to index their capital gains for inflation, those who hold long term investments are penalized when they sell their assets. Timber owners are particularly vulnerable to this problem due to the long-term nature of forestry investments.

The 1986 tax changes created major disincentives for landowners with forest land; higher tax rates and inability to index made reinvestment in forestry an unattractive proposition. Less money is available for reforestation after capital gains taxes are paid. High capital gains taxes put additional pressure on landowners to convert their lands to non-forest uses. As you heard from the forestry witnesses on January 25, since the tax code changes of 1986, tree planting is down and conversion of land to non-forest uses is up.

The NASF has endorsed the Congressional Forestry 2000 Task Force's Reforestation Tax Act for the last several years. In addition to the reduction in the capital gains tax rate contemplated in H.R. 9, we would hope the committee would also consider the following changes:

- allowing adjustment of timber capital gains for inflation;

• amending the passive loss rules to take into account the nature of forestry investments and management;

• increasing the reforestation tax credit to encourage reforestation and con servation of land in forest uses.

• allowing landowners to amortize reforestation expenses and to index these expenses for inflation.

Such changes will not only provide tax relief to one of the most important segments of our economy but provide an incentive for the type of forest management that produces multiple benefits (such as clean water, clean air, productive soils, and wildlife habitat) for the long-term.

While your committee does not have direct jurisdiction over forestry issues, you have as much power to positively effect management decisions as those that do. We hope you will consider making positive changes in the tax code which recognize the long-term, risky nature of forestry investments. We look forward to working with you as you re-examine the capital gains tax system. Please consider this letter as NASF's written testimony before your committee on this issue.

Please feel free to contact Terri Bates, NASF's Washington Representative, at 202/624-5415 if you have any other questions.

Sincerely,

William A. Farris
President

STATEMENT OF MR. J. DREW HIATT EXECUTIVE VICE PRESIDENT DIRECTOR OF GOVERNMENT AFFAIRS THE NATIONAL BUSINESS OWNERS ASSOCIATION ON THE JOB CREATION AND WAGE ENHANCEMENT ACT JANUARY 24, 1995

Mr. Chairman, Mr. Gibbons, and Members of the Committee, my name is J. Drew Hiatt, and I am Executive Vice President and Director of Government Affairs for the National Business Owners Association. We appreciate very much the opportunity to present our views on the tax and business investment incentives contained in the Job Creation and Wage Enhancement Act of 1995 (H.R. 9), particularly as they affect American small business men and women.

The National Business Owners Association represents nearly 5,000 small business owners, and has an active and expanding membership. Its philosophy is based on the belief that a vibrant and robust private sector and a strong and competitive free enterprise economy are essential to create and increase economic growth, opportunity, jobs, and prosperity for all Americans. NBOA vigorously represents the interests of its members before Congress as well as federal, state, and local government. It also works to influence and enact national policies that promote economic growth and entrepreneurship. As part of its efforts to advocate and adopt beneficial laws and regulations, NBOA consistently communicates the concerns and legislative priorities of business owners to lawmakers, government officials, the public, and the media

We commend you, Mr. Chairman, for your leadership in convening this hearing today to examine how changes to the tax code proposed in the Job Creation and Wage Enhancement Act will create a more favorable economic and entrepreneurial climate. Your support of this legislation underscores your longstanding commitment to promoting and enacting sound fiscal and tax policies – workable policies that are based on common sense and the common good. We gratefully recognize your commitment. As a strong advocate for small business, you understand the daunting challenges that confront entrepreneurs, especially the financial consequences that taxes impose on hard-working small business owners. We appreciate your efforts as well as the understanding and concern you have shown for them over the years as demonstrated most recently by your introduction of H.R. 9. Our members support the tax and investment provisions of the Job Creation and Wage Enhancement Act in the belief that they can and will set the stage for a new American era of expanded economic growth, opportunity, and prosperity.

Small business owners will lead this new era – if their representatives on this Committee and in Congress will give them the chance. As the powerhouse of the economy, small businesses know how to lead. America's nearly 22 million small business owners generate about 40 percent of our gross national product and provide more than half our goods and services. Small business is the nation's leading employer. Today, six in 10 Americans take home a paycheck from a small firm. Small business is not only the nation's leading employer, it is also the major provider of new jobs. Over the last five years, small firms have created nine of 10 net new jobs. In fact, according to the U.S. Small Business Administration, they are expected to create more than three-quarters of the 43 million new jobs needed over the next 25 years.

We encourage you, as members of this Committee, and the Congress at large to enact the policies necessary for small business to create the economic growth America needs. Unless this Committee and this Congress remove the roadblocks and reform the policies that hold back small businesses, they will never achieve their full economic potential and all Americans will suffer the consequences – in lost opportunity, lost growth, and lost jobs. It is true that small business owners are succeeding in spite of these restrictive policies. But they are succeeding against the odds and obstacles because of their determination, hard work, and tenacity. If Congress removes the obstacles, there is no limit to what they can achieve. We believe there is a historic opportunity now to abandon these limiting policies. Lawmakers of both parties should work together to lay the groundwork that will help create the new American era of economic growth.

What's Wrong with Our Tax Policy?

On average, the U.S. economy invests 15-20 percent of its income in a given year. Is it enough? Our goal should be to create an economic climate in this country that is conducive to investment. It is investment that fosters economic growth, prosperity, job creation, and wage growth. We say that we are serious about and committed to investment. We say this is one of our highest national priorities, one our highest public policy goals – but is it really? Judging from the way in which revenues from investors and investments are taxed in this country, investment may not be as high a priority as some in Congress believe or declare it to be. Our tax code punishes, not rewards, the very thing and the very people – risk-taking and risk-takers – that Congress professes to support. At best, it is a logical inconsistency and, at worst, a glaring contradiction to say that Congress, as a whole, encourages investment as a matter of public policy and national priority. It is an economic contradiction for some lawmakers to say they support investment in business startup, expansion, jobs, and economic growth and then to enact tax policies that discourage investment by levying higher – and some might argue excessive – taxes on investment. This inconsistent practice undermines and even destroys the investment business owners seek to make and nurture. Even worse, it punishes the handful of entrepreneurial risk-takers who would launch new ventures or expand businesses, and thereby denies hundreds of thousands of other Americans jobs, opportunities, and wages.

Investment fuels productivity, economic growth, and job creation. Maintaining high taxes or increasing taxes on investment does not. Congress needs to examine whether the sole goal of U.S. tax policy is to raise revenue to finance government services and programs or whether an equally valid objective of tax policy should be to encourage investment. This policy debate must focus on whether it is better to raise more revenue to support an inefficient, wasteful, bloated government that consumes wealth or to encourage more investment by allowing those who create our wealth to keep more of what they earn to invest. We believe that a dollar left in the hands of entrepreneurs can do more good than one that is sent to Washington and consumed with little or no result.

Savings and Investment: Keys to Productivity, Economic Growth, and Job Creation

Increased investment benefits the economy. But the United States has not always followed this formula for economic growth. In fact, the U.S. has devoted a smaller percentage of its gross national product to investment than almost any other industrial nation. Over the last three decades, Japan has invested 31 percent of its output and boosted productivity growth by more than five percent per year. Germany and France have earmarked slightly more than 20 percent of their output for investment, achieving annual productivity growth of more than three percent. In contrast, the United States has invested about 18 percent of its output and increased productivity growth just a little more than one percent.

Why has U.S. investment been so low? The answer is high capital costs. Savings provides funds needed for investment, and is an important source for investment capital. The problem has been that Americans do not save as much as many foreigners do. Consequently, our national rate of savings is one of the lowest worldwide.

An international survey conducted by the American Council for Capital Formation found with regard to personal saving incentives that the United States ranks among the lowest on a list of twelve countries. The U.S. capital gains tax rate on long-term gains on portfolio securities is higher than that of all other countries except Australia and the United Kingdom and even these countries index the cost basis of an asset for inflation. Four of the twelve nations tax interest income at rates below the U.S. maximum rate. Total income taxes (individual plus corporate) on dividends are lower in most countries than the United States because most other countries have some form of dividend tax relief. Individual retirement account deductions were found to be more generous in five of the twelve countries than they are in the United States. The study also found that half of the twelve countries allow deductions or tax credits for life insurance premiums, while the United States does not. And individual social security contributions to government-sponsored plans are deductible in most of the twelve countries, while they are not in the United States.

In view of weak U.S. savings incentives, it is no wonder that the U.S. personal savings rate, which averaged nearly 7 percent of disposable income over the 1975-1991 period, is far below that of our major competitors. The study found that Japan, for example, had a personal savings rate for this period of 17.3 percent; Germany's rate was 12.7 percent; Canada's was 12.5 percent. The increase in the personal savings rate is important in promoting U.S. economic growth and providing funds for investment.

In recent years, private savings has been diverted away from investments and used to finance public deficits and government spending. This has also contributed to higher capital costs. The resulting problem is that less money is available for investment or, where it is available, its cost is prohibitive.

Today, the great debate focuses on the best way to encourage investment. The best strategy for boosting investment is to create incentives for private investors. Cutting the tax on capital gains is one example of an incentive that would work. Reducing the tax will encourage investors to buy stocks of companies that retain earnings. This will lower the firms' cost of capital, while providing incentives for saving. Investment income that is taxed encourages consumption at the expense of savings. What we need is to promote investment and savings for the long haul. This is the key to productivity, job creation, and economic growth.

Investing for the short-term is short-sighted. Entrepreneurs need to invest today for the future. They need "patient" capital, long-term capital. Because entrepreneurs need patient capital, it is critical to eliminate the obstacles that often discourage investment for the long run. Business owners and aspiring entrepreneurs must have capital in adequate supply to grow companies and launch new ventures. Congress' goal should be to create a highly favorable investment climate that will enhance and accelerate economic growth, business expansion, and job creation on an unprecedented scale.

Due to the realities of a global economy, it is necessary to encourage higher levels of investment and spending in the U.S. economy. American businesses and workers will continue to compete for customers against major competitors in Japan and Europe, as well as in the strong and emerging economies of the developing nations. Increased investment generates more productivity, which is the cornerstone of true economic wealth. Throughout our history, we have led the world because of our willingness to invest in new ideas, new opportunities, and people. This has helped us create the world's largest and richest economy. We will always reap the reward of investment today, but the United States must become a nation that saves and invests for the future if it is to remain the world's economic leader tomorrow.

A New Direction for U.S. Tax Policy: Toward A More Investment-Driven Policy and Economic Growth

A new direction in U.S. tax policy is needed to ensure that American businesses, particularly entrepreneurial small businesses, will be free to create the growth and jobs our nation needs. Maintaining or levying higher taxes on investors and investment is contrary to the national objective of long-term economic growth and employment. That is why we need an investment-driven tax policy, one that will promote investment by lowering taxes on profits and creating more capital formation for increased investment.

Small business owners are leading the nation in economic growth and job creation. Yet, the tax code offers very little help in the form of incentives that would assist small business owners in creating more jobs and growth through investment. It is important to remove additional disincentives to investment. A new direction in U.S. tax policy would recognize that the sole purpose of tax policy is not only to fund government services and programs, which is merely a collection of revenues, but that an equally important priority is to encourage investment that will contribute to economic growth, job creation, and prosperity for all Americans.

We must encourage Americans to save more to promote capital formation for investment in growth and jobs. We must remove the disincentives for savings that lead to consumption of income and instead provide incentives for Americans to save more of their income. Ideas such as American Dream Savings accounts, as proposed in the Contract with America, take a step in the right direction toward creating an environment in this country that will encourage savings. Unless Americans begin to save more, American businesses will continue to pay the price for the high cost of capital and this price will be reflected in lower levels of productivity, less economic growth, and fewer jobs for all Americans. Lowering the capital gains tax rate and adjusting gains for inflation would help increase investment. This would create large pools of capital for companies – both start ups and existing companies – to tap for economic growth. It would also create a tremendous potential for enormous economic expansion, for risk-taking, and for new technological development, all of which we need to become more competitive with foreign countries. Congress needs to remove the obstacles, the barriers in the tax code that make it more attractive to consume income rather than to save and invest it.

We need to provide additional incentives for entrepreneurs to invest in their businesses and to recover the full and real cost of their investments. At present, small business owners who invest in their companies are unable to recover the full cost of their investments in depreciable property because inflation erodes the present value of their investments and the time value of money is not accounted for in current write-offs. It is important to remove these obstacles to increase investment.

Disincentives for savings and investment that are ingrained in our current tax code must be replaced with incentives for savings and investment. This will put our nation on a path of growth and economic security in the years ahead.

THE JOB CREATION AND WAGE ENHANCEMENT ACT

Cutting Capital Gains and Indexing Them for Inflation

The House Republican Contract with America includes three capital gains incentive provisions: (1) a 50 percent capital gains deduction, (2) indexation of capital gains for inflation, and (3) allowing homeowners who sell their homes at a loss to deduct that capital loss. The 50 percent capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1995. The capital assets indexation would apply to inflation (and sales of assets) after December 31, 1994.

Fifty Percent Capital Gains Deduction

The bill would allow taxpayers – both individual and corporate – to exclude one-half of capital gains from income tax, with the effect of cutting the capital gains tax rate to one-half the rate of ordinary income, which currently is capped at a rate of 28 percent. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending upon the individual's tax bracket. Corporations would be subject to a top effective tax rate of 17.5 percent. The measure would not change the 1-year holding period requirement for long-term capital gains.

The 50 percent capital gains deduction would be taken against gross income. This change would ensure that the excluded half of the capital gain would not increase Adjusted Gross Income (AGI). Because capital gains are currently included in AGI, many taxpayers must forfeit personal exemptions and itemized deductions if they are above certain income thresholds. This change would have the effect of reducing the effective tax rate on capital gains by easing the impact of the personal exemption phaseout and the limitation on itemized deductions.

The capital gains deduction would not be a preference under the Alternative Minimum Tax (AMT). Therefore, the 50 percent deduction would be excluded from the AMT. This exclusion helps taxpayers avoid another tax rate on capital gains.

The bill would also reinstate the pre-tax Reform Act of 1986 rule for capital losses: only one-half of net long-term capital losses, to the extent that they exceed net short-term capital gains, would be deductible.

Capital Gains Indexation

The bill would halt the practice of taxing individuals and corporations on inflated capital gains. Under current law, taxpayers must pay capital gains taxes on the difference between an asset's sales price and its basis (the asset's original purchase price, adjusted for depreciation and other items), although the increase in value may be the result of inflation and not real gain. The measure calls for increasing the basis of most capital assets to account for inflation after 1994. Taxpayers would be taxed only on real, not illusory, gains.

Loss on the Sale of a Home

Under the bill, taxpayers who sell their principal residence at a loss may deduct that as a capital loss. Current law does not allow homeowners who sell their homes at a loss to take this deduction.

Why a Cut in Capital Gains Is Needed and Why Gains Should be Indexed

Capital is the lifeblood of enterprise and economic growth, yet too often risk-takers – energetic entrepreneurs with promising ideas and practical dreams – encounter obstacles in obtaining the capital they need to launch a new venture. Even well-established business owners – with strong track records and profitable companies – can run up against the same problem when seeking additional sources of financing to expand their operations. Our nation's future success depends on entrepreneurs and small business owners who can help fuel and drive our economy. They create our jobs and contribute to our growth and prosperity. But without the capital to start and expand businesses, they cannot succeed and ultimately we will all pay a price for their lack of success. It is time that Congress address the need for increased capital availability within the context of efforts to encourage increased business formation and expansion through investment. The current tax treatment of capital gains is an obstacle to the formation of additional capital that entrepreneurs must have access to for investment in growth and jobs.

The Effects of Taxing Capital Gains

Reduced Savings and Its Effect on Capital Formation and Investment

Subjecting capital gains to taxation penalizes those who save and invest, forcing them to pay tax not once but twice on the same income. From the standpoint of tax equity, the capital gains tax is punitive and discriminatory. High tax rates on capital gains tend to discourage savings because they lower the after-tax rate of return on savings. Such rates can distort individual decisions about savings. Faced with a choice between saving income – with a lower rate of return later – or spending it now, many Americans elect to consume income now rather than defer future consumption through savings. Since savings is essential for capital formation, the individual preference for current consumption, as compared to saving for future consumption, stymies capital formation. Reduced availability of capital equates to lower levels of investment in business startup, plant and equipment as well as in labor, with the consequence that productivity suffers and workers' wages can drop.

Decreased Risk-taking and Investment

High capital gains tax rates discourage venture capital and risky investments and harm small firms and new enterprises. These investments are critical to our nation's growth and economic success. Over the last several years, entrepreneurial small companies have contributed to and accounted for nearly all of the economy's growth and job creation. Growing and emerging new companies need steady infusions of risk capital to nurture, support, and sustain expansion. Entrepreneurs need investors to buy stock and to invest in their companies. But investors will only commit their capital to such investments if they can be assured of a fair and reasonable return on their investment.

The taxation of capital gains acts as a significant drawback to riskier investments in new startup companies or those undertaking expansion. A lower capital gains tax rate would help channel more capital into new and growing small entrepreneurial companies – the nation's leading source of economic growth and job creation. This, in turn, would create a tremendous potential for increased economic expansion, encourage risk-taking on a larger scale, spur innovation, boost productivity, and add more Americans to company payrolls.

The Threat to U.S. Competitiveness

Higher capital gains tax rates undermine U.S. industrial competitiveness and threaten to challenge our longstanding role as the undisputed economic leader of the world. Capital is the key ingredient of investment and investment fuels growth and expansion; however, when capital costs too much, investment declines and productivity and economic growth suffer. Higher capital gains rates tend to discourage savings and investment, raising the cost of available capital. The effect of higher capital costs – either because of reduced supply or increased demand – is lower levels of investment in plant and equipment, technology, and labor. As a result, goods and services that are produced under this scenario cost more to produce. These costs must be reflected in higher consumer prices, making products less price competitive in the marketplace.

The United States already faces significant competitive challenges around the globe. In many cases, our competitors benefit from more favorable tax treatment of capital gains and savings, combined with lower labor, raw materials, and overhead costs, as well as reduced regulatory and paperwork burdens. This strengthens their advantages and increases their opportunities in the marketplace. Congress needs to stimulate business investment in technology, plant and equipment, and people to maintain our technological superiority, boost productivity, and increase our global competitiveness. That is why a lower capital gains tax rate is needed to reduce the cost of capital and to increase its availability.

Locking in Investors and Investments

Investors who contemplate selling assets or changing their investments understand the effect capital gains taxation has on anticipated profits from asset sales. They must weigh whether the expected return from the sale of an asset will result in a desired profit after the capital gains tax has been levied. When it is clear that the profit is less than expected, investors will generally for go or postpone the sale of an asset. This phenomenon of investors holding onto assets because the expected net return derived from the sale of an asset after the payment of capital gains tax is less than desired is known as the "lock-in" effect.

Taxing capital gains often saddles investors with assets they do not want but cannot afford to liquidate because of the undue financial consequences. This can cause capital to idle in non-productive assets. Moreover, the lock-in effect deters the redeployment of capital to more useful and productive investments. Since the lock-in effect caused by higher capital gains taxation can distort behavior, many investors seek out investments that will minimize tax liability. In such cases, tax avoidance becomes a major strategy in considering investments, rather than pursuing investments that make good economic sense and, while riskier than others, also provide higher rates of return.

Lowering capital gains taxes would unlock a huge amount of wealth in homes, land, farms, stocks, bonds, and other assets; and free investors to pursue new investments. Simultaneously, it would generate new revenues through increased realizations of capital gains.

Inflation

Of all the negative effects of taxing capital, perhaps none is more pernicious or harmful than inflation. The current tax treatment of capital gains is discriminatory and confiscatory, since taxes are paid on inflated and illusory, not real and actual, gains. Inflation erodes gains. Under current law, capital gains taxes are applied to nominal gains, which are gains that are not adjusted for inflation. This means that the effective tax rate on real capital gains is actually higher than the current prescribed legal rate. Since the appreciation in value of most assets, particularly those held for longer periods, is attributable to inflation, taxing nominal gains destroys the wealth of entrepreneurs, individuals, and families.

Capital gains must be indexed for inflation to halt the taxation of gains based solely on exaggerated values. This would help investors who currently avoid selling assets to take advantage of higher risk investments – the chief source of economic growth. Further, it would allow investors to buy assets based on their true merits without regard to the effect of inflation on future returns or plan sales of assets based on artificial holding periods. Indexing capital gains for inflation also would help small business owners who want to sell assets to create or expand a business or sell their company.

In Defense of a Capital Gains Tax Cut: Answering the Critics

Critics of reducing the rate of capital gains have attacked the proposal on many fronts.

Argument: A Capital Gains Tax Cut Only Helps the Rich

Many charge that cutting the capital gains rate will disproportionately benefit taxpayers in higher income brackets. They contend that at least half of the direct benefits of a cut in capital gains will go to the top two percent of taxpayers nationwide. Opponents are concerned that this will result in a windfall to America's richest individuals and corporations at a time when there is a growing disparity between the country's rich and poor.

Underlying much of the opposition to reducing the capital gains tax is a false belief about our economy: that is, if one individual wins, the other must lose. Investors who save and invest their income and plough it into productive investments not only help themselves, but also countless more who share in the benefits from the initial investment. The direct benefits of investments include economic growth, increased productivity, new jobs, higher wages, and improved living standards, to say nothing of additional revenues that government realizes. Thus, investments produce a strong multiplier effect within the economy, helping investors and those who are beneficiaries of their investments. To paraphrase President Kennedy, 'a rising tide of investment lifts all boats.' But when higher capital gains taxes punish investors by devouring the value of their investments or diluting them through the taxation of inflated gains, they respond by saving and investing less. Ultimately, their reluctance – or refusal – to save and invest hurts the economy and everyone in it.

If Congress wants to create more jobs, expand the economy, improve income and wage opportunities, it must encourage more investment. To foster greater investment, Congress must first remove the disincentives to savings and investment – for rich, middle-class, and lower middle-class investors alike. Individuals respond positively to investment incentives, but they react negatively and predictably to investment barriers such as higher capital gains rates. Congress must create incentives for risk-taking, job creation, and expansion. Lowering the capital gains rate is a first step. This reform would help all income classes because it would improve the economy's performance and growth potential. It is a tenet of sound economic policy that economic growth increases when the cost of activities that foster it are lowered.

Critics of lowering the capital gains tax deride it as a boon to rich taxpayers. They labor under a false assumption; namely, that all those who pay capital gains taxes are rich. Low- and middle-income taxpayers bear a significant share of the cost as well. The reality is that many Americans with limited incomes have investments in stock, rental properties, and small businesses. They face the capital gains tax when they sell such assets. Michael Schuyler, Ph.D., of the Institute for Research on the Economics of Taxation, found that:

> Most distributional tables purporting to show who pays the capital gains tax overstate the wealth of people with capital gains because they include in a taxpayer's income the entire capital gain in the year in which the person realizes the gain. Since gains are typically realized irregularly, people tend to have unusually high incomes in the years when they realize their gains. A better measure of income is found by averaging the gains over several years' before adding them to income. And these corrected tables indeed show that the middle-class forks over a significantly higher share of the capital gains tax than is usually acknowledged. In addition, as politicians in Washington have sought higher taxes to finance more government spending, they have frequently found it convenient to redefine "wealthy" at lower and lower income levels.
>
> *Cut The Capital Gains Tax To Help All Income Classes*
> IRET Byline. September 22, 1989 No. 79

A high capital gains tax rate should not be used to extract more taxes from income earners in the top tax brackets any more than it should be used to punish those who are in lower and middle-class income brackets. Lowering the tax on capital gains has the potential to help Americans in all income classes by sparking greater growth in the economy.

Argument: A Capital Gains Tax Cut Will Break the Treasury and Increase the Deficit

Opponents of a lower capital gains tax rate maintain that reducing the rate could cause the budget deficit to rise unless Congress offsets the tax cut with spending cuts. They say that Congress must find the cuts or risk further interest rate hikes by the Federal Reserve. Opponents also argue that a cut would kill prospects for improved economic growth that Republicans say they want to stimulate. The Congressional Joint Committee on Taxation estimates that the Republicans' proposed capital gains tax cut would cost $56 billion in lost tax revenue over the next five years. After that, it predicts, the cost of a capital gains tax cut would rise, mostly due to proposed adjustments in future capital gains to offset inflation. Opponents point out that Congress cannot dismiss the fact that the $160 billion deficit will begin rising again next year, and that the costs of the capital gains tax cut would add to that cost without offsetting spending cuts.

Republicans have vowed to cut spending to make room for the cuts they propose. The capital gains tax cut will not be a revenue loser as critics contend; in fact, it could prove to be a net revenue gainer. Mr. Gary Robbins, President of Fiscal Associates Inc, a leading proponent of dynamic estimating, predicts that the capital gains tax cut would produce $126 billion in new revenues by fostering widespread economic growth. We believe this could result in a windfall to the U.S. Treasury. A lower capital gains rate could boost tax revenues by encouraging investors to realize their gains sooner. A cut would encourage investors to liquidate assets and put their money into productive investments to such a degree that the cost of a capital gains tax cut would pay for itself in higher tax revenues later.

Critics say this is an unproven economic hypothesis. Yet, Warren T. Brookes, a respected journalist and economist, recounts in his book, *The Economy in Mind*, that the opposite is true:

> When the top marginal tax rate on capital gains was 46% (1946-63), or nearly double Mellon's maximum range of 25%, the taxes paid on capital gains steadily declined from 1961 through 1963. Then, as a result of the Kennedy across-the-board tax cut of 1963-64, the top marginal tax rate on capital gains was reduced from 46% to 35% – a cut of 24%. The revenues from this tax steadily rose, by 25% in 1964 and 27% in 1965. By 1968 they had nearly tripled in constant dollars, at a substantially lower marginal tax rate.
>
> Unfortunately, this growth in capital gains and investment was hit hard, first by a surtax in 1968-69, and then by an increase on capital gains put through by Senator Edward M. Kennedy in 1969, which had the effect of raising the top marginal tax on capital gains to its highest level in U.S. history, 49% in 1970. The results were immediately destructive. Tax revenues from capital gains plummeted, and over the next eight years remained consistently at a level nearly $1.5 billion lower than they were in 1968.
>
> Within a year of this tax increase, the entire equity capital market for small companies (which account for over 80% of all new jobs and 65% of new inventions) fell apart; and it continued to disintegrate over the next eight years. In 1969, before the tax hike, there were nearly 700 new stock offerings by small companies, with a total 1980 value of nearly $3 billion. But by 1977 this equity market had shriveled to only 13 offerings and less than $55 million – a compound annual decrease of nearly 40%, the worst collapse in equity sales in modern U.S. history.
>
> For all intents and purposes, Senator Kennedy's innocent little tax hike had virtually killed off the small-business equity market and countless thousands, even millions, of jobs along with it.
>
> *The Economy in Mind*, pp. 59-61

Later in the same chapter, Brookes describes the effort involved in trying to reverse the increase on capital gains.

> It was perhaps the best illustration of the Laffer Curve in action – so good, in fact, that a young Republican congressman, the late William Steiger of Wisconsin, decided in 1977 to try to convince an overwhelmingly Democratic Congress to repeal this massive mistake [sic: Senator Edward Kennedy's bill to raise capital gains] by showing his colleagues that as much as half of the new equity capital for the nation's fast-growing high-technology industries was, by now, coming from overseas rather than from our own equity markets.
>
> The dramatic fall, both in capital-gains tax revenues and in equity-investment, convinced the Congress to turn down President Carter's own surprising plan to increase the capital-gains tax rate still further (to 52.5%) and instead to adopt Congressman Steiger's amendment, which cut the rate from the 49% level down to 28% – a 43% tax reduction.
>
> The Carter administration, in an unsuccessful attempt to block this bold move, had warned that the Steiger Amendment could reduce Treasury revenues by more than $2 billion during the first year. Instead, the Steiger cut actually *raised* capital-gains tax revenues modestly in 1979, the first year following the 43% reduction, as the number of new equity offerings suddenly jumped from 20 per year to 81 in 1979. Then, during 1980, a recession year, 237 companies offered stock to the public for the first time (the greatest number since 1972) and sold $1.4 billion in shares -- a huge increase from the 81 new

companies that had sold $506 million in 1979.
The Economy in Mind, pp. 61-62.

NBOA Position on Cutting Capital Gains and Indexation

The National Business Owners Association strongly supports the capital gains tax cut and indexation provisions contained in Job Creation and Wage Enhancement Act as introduced and as originally proposed in the Contract with America. We asked our members in a survey whether they would favor a capital gains tax cut. Respondents overwhelmingly expressed support for legislation to reduce the rate of taxation on capital gains. NBOA believes that the capital gains relief incentives included in the bill will create a climate that will encourage investment; promote increased growth in the economy, jobs, and wages; and strengthen U.S. competitiveness.

Neutral Cost Recovery

The House Republican Contract with America includes a neutral cost recovery proposal. This proposal would increase depreciation deductions to approach the economic equivalent of expensing. Currently, the tax code does not allow businesses to recover fully (on an economic basis) the cost of investments in depreciable business property. The proposal would increase depreciation deductions to account for inflation and the time value of money. The neutral cost recovery provisions would generally apply to property placed in service after December 31, 1994.

Current law prohibits company owners from taking an immediate write-off for the investments they make in depreciable assets such as plant, equipment, and other assets. Consequently, they must spread the write-offs over longer periods. This practice hurts small business owners in several ways. It reduces the real present value of the write-offs since they do not account and compensate for the twin effects of inflation and the time value of money. By not allowing business owners to factor in the costs of inflation and the time value of money and to adjust their write-offs on depreciable property to reflect these costs, business owners are unable to recover the full costs of their investments.

Under the neutral cost recovery proposal in the Job Creation and Wage Enhancement Act, businesses would be allowed to recoup the cost of their investments. The plan would allow companies to adjust their depreciation write-offs yearly by applying a 3.5 percent discount rate and the rate of inflation. This would make the write-off amount equal to the full purchase price of an asset.

NBOA Position on Neutral Cost Recovery

The National Business Owners Association strongly supports the neutral cost recovery provisions contained in H.R. 9. This bill will give entrepreneurs a powerful new investment incentive, allowing them to recover the full value of an investment in new machinery, equipment or technology over the useful life of an asset. Moreover, these changes recognize the importance of capital to small business and its ability to invest for future growth. We believe further that this provision will exert a positive influence on investment and wages as it seeks to correct an inequity in the current tax code that harms small business. These changes will also help promote rapid economic growth by spurring increased investment. We believe that such growth will fuel business startup and expansion, as well as spark new job creation.

Increasing the Expensing Level for Small Business

The House Republican Contract with America also proposes an increase in the amount of property that a small business can "expense" or deduct in the year of purchase. Current law allows a small business (a business purchasing $200,000 or less of eligible property) to take an immediate deduction on the first $17,500 of property it acquires. Remaining property is generally subject to regular depreciation rules. The proposal would allow small businesses to fully deduct an additional $7,500 from each year's earnings for purchases of equipment and inventory up to $25,000, compared with $17,500 now. The provision would be in effect for taxable years beginning after December 31, 1995.

Expanded write-offs for investments in plant and equipment for small business are needed to ensure that small firms have access to capital to invest in growth and expansion. Entrepreneurs need to invest today for the future and long-term investment must be nurtured. Yet, the present tax treatment of investments in plant and equipment has not favored long-term investment as it should nor has it favored the investments of small business men and women who are driving our nation's growth.

NBOA Position on Increasing Expensing for Small Businesses

The National Business Owners Association strongly favors the proposal to increase the expensing amount for small businesses as contained in the Job Creation and Wage Enhancement Act.

This legislation provides an important investment incentive for small business owners, while enabling them to recover more of the cost of their investments. This, in turn, will increase the availability of additional capital for future investment.

Clarifying the Home Office Deduction

H.R. 9 would clarify the home office deduction by making two changes. First, an office in the home would qualify as a principal place of business if the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular basis by the taxpayer and the office is necessary because the taxpayer has no other place to perform those activities. Second, qualifying home office expenses would also include those allocable to the storage of product samples. The changes to the home office deduction generally would be effective for taxable years beginning after 1995.

The home office deduction was restricted by a 1993 U.S. Supreme Court decision in *Commissioner v. Soliman*, when the court denied certain deductions and imposed two additional tests for determining eligibility for deductions. To qualify now, a business owner must: meet clients or customers in the home office; and second, earn the firm's revenue there as well. The *Soliman* decision penalizes many small business owners because they choose their homes as their business location rather than a store front, office building or industrial park. This ruling fails to recognize the fundamental realities of American business today, including its changing nature; how, when, and where business is conducted; as well as the needs of entrepreneurs who are leading our economy.

The bill would restore the deduction for home office expenses to pre-*Soliman* law. Taxpayers would not be required to meet the criteria determined by the Court. Rather, the bill allows a home office to meet the definition of a principal place of business if it is the location where essential administrative or management activities are conducted on a regular basis by the taxpayer. To avoid potential abuses, the bill would require that taxpayers have no other location for the performance of the administrative or management activities of the business.

The home may be the best incubator for fledgling businesses that are struggling to survive and succeed. Few new small business owners, if any, can afford the luxury of rented office space. That is because a major problem facing new enterprises is cash flow. Many entrepreneurs launch new firms on a shoestring budget, enduring long hours, limited resources, and lean or no profits before they become successful. For these business owners, the home office deduction can boost the chances that the company they have started and worked hard to build will be a success. That is why the loss of the deduction represents a major blow to those whose success often hangs in the balance and hinges on taking advantage of every break that can keep a company financially afloat and growing.

The *Soliman* decision ignores the changing face and needs of business. The advent of advanced and ever-improving computer and telecommunications technology has empowered millions to work from their homes. Entrepreneurs are no longer tied to an office or to a store front. Now, thanks to technology, they can work from their homes. Technology has changed the way we think, communicate, work, and do business – and where we do these things. New technologies are revolutionizing business and helping us realize huge improvements in productivity and service. As technology becomes cheaper due to innovation, more Americans can afford to work for themselves and from their homes. U.S. tax policy should not discriminate against home businesses because a taxpayer chooses to operate a business out of the home.

NBOA Position on Clarifying the Home Office Deduction

The National Business Owners Association strongly supports efforts to restore the home office deduction. Restoring the home office expense deduction could affect between 20 and 40 million Americans who work from their homes.

Increasing the Estate Tax Exemption

The Contract with America would raise the estate and gift tax exemption equivalent to $750,000. The current $600,000 exemption has not been increased in several years and has been eroded by inflation. The increase in the exemption would be phased-in. The exemption would be $700,000 for estates of persons dying, or for gifts made, in 1996. The exemption would be $725,000 in 1997 and $750,000 in 1998 or later. The $750,000 exemption amount would be indexed for inflation.

Estate taxes are hurting family-owned businesses, especially smaller firms. Funds that could be retained in a business to invest in growth and create jobs are going to pay taxes on the assets of the deceased owner or the owner who desires to exit his or her firm and hand over control to the next generation. The accounting firm of Arthur Andersen estimates that the transfer taxes on business assets above the current $600,000 exemption range from 38 percent to 60 percent, depending on amount. Surviving family members frequently must sell part of the company to pay the estate taxes. According to Mr. Drew Mendoza, program director of the Family Business Center at Loyola University-Chicago, meeting this tax burden forces many family businesses into sale or foreclosure. A survey found that nine of 10 family successors' businesses failed shortly after the original owner's death, due to the difficulty of paying estate taxes. Seventy percent of all family businesses will not succeed to the second generation and only 13 percent will make it to the third generation.

According to a recent research study conducted for Massachusetts Mutual Life Insurance Company, 57 percent of owners say they intend to pass on their ownership positions to a close relative. This represents an eight percent drop-off from the 1993 study, when 65 percent of those surveyed said they intended to keep the business in the family. It is an alarming statistic, and points to a possible disturbing nationwide trend: we are losing family-owned businesses. Higher estate taxes may be the culprit or only a single factor contributing to the decline of America's family-owned businesses. These firms are important to our nation's economy. It is estimated that there are 10 million to 12 million family-owned businesses nationwide. These companies may account for as much as half our gross national product and 60 percent of all wages paid.

With all the daunting challenges and obstacles already facing small business owners, the tax code should not add to the burden of family business owners by making it more difficult for them to keep their companies in family hands. We need to preserve family businesses by removing obstacles -- such as higher estate taxes -- that threaten their prospects for continued survival and success.

The last estate tax reform occurred in 1981, when the high inflation of the 1970s forced Congress to alter the existing law. The tax rate was reduced from 70 percent to 50 percent, the tax exemption was raised from $200,000 to $600,000, and further taxes were deferred on the portion of the estate the spouse inherited. These changes were only adequate for a short time. Small business owners say the current rate has not kept pace with the state of the economy and they need to be overhauled again.

NBOA Position on Raising the Current Estate and Gift Tax Exemption

The National Business Owners Association strongly supports raising the current estate and gift tax exemption to $750,000 and adjusting it for inflation. This change will help ease the burden of estate taxes for many small business owners, keep family firms financially stable, and preserve them for generations to come.

CONCLUSION

We appreciate this opportunity to offer our views on the tax and investment incentives contained in the Job Creation and Wage Enhancement Act. These incentives will set the stage for a new American era of economic growth led by small business owners. The real growth in all major economies worldwide is coming from smaller, more entrepreneurial companies. That is especially true of the U.S. economy. The importance of entrepreneurs and small business owners to the economy cannot be underestimated. They drive the American economy, fueling its growth, adding new jobs, and creating wealth.

Congress must help unleash the entrepreneurial spirit to spur economic growth and encourage individuals with promising ideas and the courage to take risks to start and expand businesses. Too often government creates obstacles to growth as it has with disincentives for savings and investment. Small business owners deserve policies that promote economic growth -- policies that reward, not punish, risk-taking and hard work. The tax and investment incentives in the Contract with America are a bold and promising step in the right direction.

Mr. Chairman, we look forward to working with you and the Members of this Committee over the coming months to develop and enact the policies that will help America's nearly 22 million small business owners bring about a new American era of economic growth and prosperity.

TESTIMONY OF JOHN C. GOODMAN
NATIONAL CENTER FOR POLICY ANALYSIS

The Individual Retirement Account program, first established by the Pension Reform Act of 1974, was one of the most successful programs ever adopted. People could make tax-free contributions to an IRA and pay the taxes at the time of withdrawal. By 1984, 15.4 million taxpayers were depositing $35.8 billion per year in IRAs. Studies by Professors Steven Venti of Dartmouth, David Wise of Harvard, Glenn Hubbard of Columbia and Jonathan Skinner of the University of Virginia clearly showed that IRAs increased the rate of personal saving. Their studies showed that as much as 80 cents of each dollar deposited to IRAs represented new savings. If we assume that the average depositor was in the 35 percent income tax bracket, for each $1 increase in the federal deficit more than $2 of new savings was added to the credit market. Thus IRAs financed an increase in private investment which led to increased tax revenues that offset government deficits.

The Drop-off in IRA Contributions. The Tax Reform Act of 1986 removed many of those who had been making tax-free IRA contributions from eligibility. It limited the tax-free contribution to people with no employer-provided pension or to individuals with incomes of less than $25,000 and couples with incomes of less than $40,000. The 1986 act dramatically reduced marginal tax rates, making tax advantages of IRA contributions less attractive. As a result of these changes:

- The number of people making annual IRA contributions dropped from 15.5 million in 1986 to 6.4 million in 1988 — a decrease of almost 60 percent.

- The total amount contributed to IRAs each year dropped from $37.8 billion in 1986 to $12.0 billion in 1988 — a decrease of almost 70 percent.

The NCPA estimates that 45 to 50 percent of the decline in IRA participation was due to the income limits. The remaining drop in participation was due to the drop in marginal tax rates. In general:

- The average marginal tax rate for IRA contributors dropped from 27.1 percent in 1986 to 19.1 percent in 1988.

- As a result, the value of the tax advantage associated with IRA contributions fell by 35 to 40 percent.

Backended IRAs. The House Republicans' Contract With America proposes a new IRA — one that is "backended." Instead of making tax-free deposits and paying taxes when funds are withdrawn, with these accounts people would make aftertax deposits and tax-free withdrawals. Moreover, before age 59 1/2, funds could be withdrawn without penalty if used for the purchase of a first-owner occupied home, college education expenses, medical costs or insurance for long-term care. For two years, people holding traditional IRAs would have the option of cashing them out without penalty, paying taxes and transferring the funds to backended IRAs.

Why are backended IRAs attractive? If tax rates are the same over a person's life, paying taxes before making deposits or after making withdrawals are equally attractive — that is, the present values of front-ended and backended IRAs are the same. But tax rates will not remain constant. When IRAs were introduced, most American workers could expect to be in a lower tax bracket after they retired. Hence, it made sense to avoid taxes during the working years and defer them until retirement. With the passage of the Social Security benefit tax in 1983, an increase in 1993 in the amount of the benefit subject to tax and the reduction in marginal tax rates passed in 1981 and 1986, the traditional assumption is not necessarily true. Many workers who today are in the 15 percent income tax bracket will be in the 28 percent bracket by the time they retire. The Social Security benefit tax can further increase their marginal tax rate to 52 percent. The backended IRA addresses the problem of higher marginal tax rates for the elderly by providing for aftertax deposits during the working years and tax-free withdrawals later.

With backended IRAs there is no initial tax revenue loss. Revenue would increase in the short run because people who have IRAs now would transfer funds to the backended IRAs and pay regular taxes on the amount transferred. Critics argue that there would be long-run revenue losses from future tax-free withdrawals. However, Professor Martin Feldstein of Harvard has countered that the backended IRA increases long-term government revenue because, like a current IRA, it increases saving, which increases the size of the capital stock, which increases output and taxable income.

Another advantage to the backended IRA is its treatment of capital gains income. Under current law, assets held for many years are taxed on increases in value due to the effects of inflation alone. Because all income is tax free at withdrawal, capital gains in a backended IRA would not be taxed, making growth assets particularly attractive.

NCPA Senior Fellows Aldona Robbins and Gary Robbins have estimated the economic effects of the backended IRA proposal for TaxAction Analysis. They conclude that the measure would result in a reduction in the overall marginal tax rate on capital by 0.6 percent and a reduction in the aftertax cost of capital to investors of 0.5 percent. The Robbinses further estimate:

- By the year 2000, annual gross domestic product would be $18 billion higher than otherwise.

- The proposal would create 42,000 new jobs.

- The federal government would gain $58 billion in additional revenue between 1995 and 2000.

The proposed expansion of IRAs is good for everybody. It will provide the average American an incentive to save more. It will produce more money to finance capital investment, economic growth and jobs. And it will increase tax revenue, both because of the initial transfer of funds from existing IRAs to backended IRAs and because of the increased output of goods and services.

TESTIMONY OF THE
NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

The National Federation of Independent Business (NFIB) appreciates the opportunity to submit testimony on the issue of allowing a tax deduction for a home based business. NFIB is the nation's largest small business organization representing over 600,000 small business owners from all fifty states. The typical NFIB member has five employees and has $250,000 in gross annual sales. NFIB sets its public policy positions through regular polling of its membership.

A provision clarifying who is able to take a tax deduction for a home based office or business is one of the small business tax items included in the Contract with America.
The economic goals of the Contract with America -- less taxes, less spending, and less regulation -- are what small business owners have wanted for years, as shown over and over again in NFIB surveys. In 1986, small business owners identified their federal tax burden as the third biggest problem facing their businesses, according to a study done in that year by the NFIB Education Foundation entitled *Small Business Problems and Priorities*. Then, a follow up study published in 1992 showed federal taxation moving up to the second biggest problem faced by small employers, second only to the rising cost of health insurance. And in the most recent study completed by the NFIB Education Foundation in October of 1994, entitled *Small Business Economic Trends*, small business owners identified their tax burden as the number one problem facing their businesses.

Small business has a huge stake in the outcome of the debate on the tax elements of the Contract. It is equally true that America as a whole has a huge stake in how small business fares in whatever tax and economic legislation this Congress passes. Evidence continues to suggest clearly that small business plays a unique and rather remarkable role as a job creator and provider of personal opportunity, security and independence for millions of Americans. Consider the following:

Jobs. Since the early 1970s, small firms have created two of every three net new jobs in this country (created jobs minus lost jobs). A substantial majority of that job growth came in the very smallest firms -- those with fewer than five employees. The nation's small business job machine has shown a capacity to produce in either good or tough times. **From 1989 to 1991, a period of minimal economic growth, firms with fewer than 20 employees created virtually all net new jobs in the country. Firms of all other sizes lost employment during that period.**

Demographics. Almost all businesses are small businesses. There are approximately five million employers in the United States. About 99 percent of them are small employers. And almost all small businesses are very small -- so-called Mom-and-Pop, Main Street, family enterprises. More than half of businesses with employees employ fewer than five people. Almost 90 percent of employers employ fewer than 20. Small business as a whole employs more than half of the private sector workforce. **Most small firms are not set up as C corporations, but as proprietorships, partnerships, and subchapter S corporations.**

Values. Small business holds out to our citizens great hope. Small business offers a road map to the American dream that allows any American with a good idea and talent to follow it to economic freedom and security by starting their own business and working hard to make it a success.

It is this culture, these values, that primarily drive people to start a business -- not because they have money or want to make a lot of it. In a 1991 NFIB Education Foundation study entitled *New Business in America*, new business owners were asked why they went into business. Answers such as "Use my skills," "Control over my own life," and "Build for the family" were all cited twice as frequently by respondents than was "Earn Lots of Money." And having money to start with is not a distinguishing factor in wanting or being able to start a business and pursue the American dream. **More than half of all businesses begin with less than $20,000 in capital. One in four of *Inc.* magazine's 500 fastest growing companies in 1992 started with less than $5,000.**

None of this should lead you to believe that surviving as a small employer is easy. To the contrary, it is difficult. About half of all businesses do not survive beyond their first five years.

There are numerous reasons why businesses fail. One of them is government -- government taxes, government red tape, government regulations, and government paperwork. That is why what you do here in the first 100 days of the 104th Congress is so important. You have a unique challenge and opportunity -- an opportunity to free small business owners and entrepreneurs from the drag of government so they can do what they do best, create opportunity and wealth for the American people. The rest of this testimony will look at how one specific tax provision included in the Contract, clarifying who can take the home office tax deduction, will encourage further small business creation, growth, opportunity and jobs.

Background

Section 280A of the Internal Revenue Code requires those wishing to take the home office deduction to use a portion of their home exclusively for business purposes. In addition, the office must be the (1) principal place of business; (2) the place used by clients or customers; OR (3) a separate structure on the same property as the home. Most of the conflict between the Internal Revenue Service (IRS) and taxpayers have focused on what constitutes a "principal place of business".

Congress enacted section 280A in order to establish a less subjective, uniform standard for determining which offices qualify for the home office deduction. Despite this effort, different courts began establishing a variety of tests to determine whether an office was qualified. The phrase "principal place of business" was the basis for most of the variations between the tests. Some courts adopted a "focal point" test, which looked at where the income is generated and where services are provided. This test proved to be too narrow and so some courts adopted a "dominant portion of the work" test to replace it. This new test would only require that the business perform a dominant portion of the business's activities from the home office.

The U.S. Tax Court rejected the focal point test and the other tests and developed its own. Under the tax court test, the court would look at the facts and circumstances of each case and determine whether or not a home office was eligible for the deduction by exploring (1) if the office was essential to the business; (2) if the office was used for a substantial amount of time; and (3) if there were other locations where this work could be done. The U.S. Supreme Court eliminated this test in 1993 and created its own in the Soliman decision.

The Supreme Court's Decision

Commissioner v. Soliman involved an anesthesiologist who visited all his patients in the hospital and did all the paperwork at home. The Court found that he did not qualify for the home office deduction because he serviced his customers and spent most of his time at the hospital. The Court through its use of the plain English definition of the word "principal", held that the hospital was Mr. Soliman's principal place of business.

The Court decided that the IRS should determine a taxpayer's principal place of business by looking at all locations where a taxpayer does business. The principal place of business should be determined primarily by the importance of the activities performed at each location and how much time is spent at each location. Taxpayers can have only one principal place of business. Mr. Soliman spent most of his working hours at the hospital with patients. As a result, the court found the hospital to be the "principal" place he conducted business.

Most of the confusion over the home office deduction is caused by the phrase "principal place of business." This phrase was supposed to mean that the office played a significant role in the running of the business. The Supreme Court, however, read the statute literally and came to the conclusion that a taxpayer can only have one "principal" place of business and that "principal place" is determined by the importance of the activities performed at each location and how much time is spent at each location. In other words, this location must be where most of the business activity takes place. Taxpayers may have no principal place of business if these

Supreme Court tests are not met.

The Impact of *Soliman* on Small Businesses

What does Soliman mean to small business owners who had been taking a deduction for their home based office or business? Consider these examples of business owners who perform administrative and management activities essential to their business at home but under Soliman are unable to qualify for the home office deduction:

A general contractor who builds homes. At his home office this business owner pays the bills for his business, which includes the building materials he uses as well as other direct costs. He also keeps all his accounting and payroll records at his home, as well as other forms and records required by the government -- such as IRS 1099 forms and I-9 forms required by Department of Justice. He uses his home office for his business telephone that is needed to negotiate bids. Under Soliman this business owner would be unable to take the home office deduction because his greatest amount of time is spent at the work site building homes. His revenue source is the homes he builds and although he is required by the federal government to keep certain records, he has no where else to perform these administrative duties. He currently is not allowed a tax deduction for his home office.

A management consultant who conducts employee leadership seminars. This business owner also needs her home office to keep billing and accounting records. But in addition to those core administrative and management duties, she also needs a place to create, produce and store items for her seminars, such as handouts, training manuals, slides and videos. In order to produce these materials, she needs a place to read and research as well as a place to design her seminars and conduct other necessary technical preparation. She needs to be able to maintain a library and a safe place to keep her equipment -- like her computer and any video equipment she owns. Under the Soliman decision she would have difficulty taking a deduction because the majority of her time is spent on site in other locations giving the actual leadership seminars. Because her main revenue source is outside her home office, it is not considered a principal place of business and so her ability to qualify for a home office deduction could be questioned.

An interior designer who performs 95 percent of her work in other people's homes. This business owner, like the contractor and consultant, also needs a home office to perform essential business activities, such as bookkeeping, accounting and other necessary forms of record keeping. Additionally, she needs a place to store these various records. Although an interior designer may spend 95 percent of her time out of her home office, she still must have a place to keep the records of time spent with each client and collect and deposit revenues in order to pay necessary business expenses. Like the other two business owners, she is unable under Soliman to take a deduction for her home office because she spends the majority of her time at other locations and her primary revenue source is meeting with clients outside the home office.

A Solution to the Problem

Since much of the controversy over who can take this deduction centers on the reference in Section 280A of the Internal Revenue Code to the home office deduction being taken on a portion of a home that is the "principal place of business," the language in the Contract addresses this problem by re-defining principal place of business. The Job Creation and Wage Enhancement Act clearly defines "principal place of business" as (1) the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic basis; and (2) the office is necessary because the taxpayer has no other location to perform these administrative and management activities.

NFIB supports this proposal. It is a big step in the right direction. We have had some concern that it may leave too much subjectivity remaining on criteria for taking the deduction, but we have been pleased with the Ways and Means Committee staff's willingness to listen to these concerns and its willingness to further clarify Congress's intent with report language using specific examples of essential administrative and management activities such as bookkeeping, recordkeeping and storage of records.

Conclusion

This issue of who is eligible for the home office tax deduction is very important to continued small business creation and growth and to NFIB and its members. Home-based businesses are the cradle of many successful enterprises both large and small. Home-based businesses will continue to increase in the information age, with fax machines and modems making it more feasible. In addition, a home-based business is an increasingly attractive option for two wage earner families in which one parent would like to be at home with the children. The home business path to independence and income should not be foreclosed because of the ongoing controversy over how and whether such a business deducts its expenses.

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Committee on Ways and Means
U.S. House of Representatives

Hearings on Savings and Investment

STATEMENT OF ALBERT HALE
PRESIDENT
THE NAVAJO NATION
ON

INDIAN RESERVATION INVESTMENT AND CAPITAL FORMATION

I am Albert Hale, President of America's largest Indian tribe, the Navajo Nation. The purpose of my Statement is to urge the Committee to include in its tax and job creation legislative package two vitally-needed measures to help induce private sector businesses to make investments on Indian reservations (the most disinvested geographic locations in America), and to facilitate the availability of capital toward that end.

Specifically, the Navajo Nation requests that the Committee adopt two complementary investment mechanisms that comprise a sensible, meaningful and necessary follow-up to the reservation-based "Indian Investment and Employment Tax Incentives" (i.e., accelerated depreciation for property on Indian reservations, and an Indian employment credit) established in the Omnibus Budget Reconciliation Act of 1993. First, the limited accelerated depreciation investment incentive must now be supplemented with a more powerful incentive that is already well-known to Congress -- the Indian Reservation Investment Tax Credit ("IRITC") that was previously: (i) enacted with bipartisan support in 1992 within a major tax bill (H.R. 11) that was subsequently vetoed, (ii) passed again by the Senate with bipartisan support in 1993 in its version of the Budget Reconciliation Act, but (iii) removed in conference in favor of the less-valuable accelerated depreciation incentive. Second, Indian tribal leaders should be provided the tools to attract and raise capital to facilitate those sought-after investments through expanded opportunities for tribes to issue bonds, the interest on which is exempt from federal taxation ("tax-exempt bonds").

I appreciate the opportunity to provide this Statement for the hearing record, and thank the Chairman and the Members of the Committee for their consideration of our position.

INTRODUCTION

Less than one month ago, thousands gathered in Window Rock, Arizona, the capital of the Navajo Nation, to join me on a special day -- my inauguration as President of the Navajo Nation. Our all-day ceremony was a joyous celebration, honoring our past and our sacred traditions, yet at the same time mindful of the enormous challenges in our future. Underlying the happiness, joy and unity of thousands of Navajo people that day was the stark reality of the challenges ahead.

Regrettably, the challenges of our future -- a new generation of Navajo leadership -- are in large measure the identical challenges that have confronted and defined the futures of generation after generation of our ancestors: devastating poverty, unconscionable unemployment, lack of infrastructure. Whether it is a "Contract With America" or a new covenant with the people, that contract will be illusory and the covenant will be broken unless dramatic action is taken now to improve the lives and living conditions on Indian reservations that are located in 32 different states across America.

Though the challenges are great, they in turn offer opportunities -- to this Committee and this Congress -- to provide the leadership that can help transform the present reality into a future of investment and jobs in Indian country.

BACKGROUND

Like some of the Members of this Committee, and so many of your colleagues in the 104th Congress, I share your elation at being newly-elected to my position. Like you, I am filled with the desire, and hope, that I can serve my constituency in a manner that will justify the trust they have placed in me. And, like you, I am fully aware that change is necessary, and that government's role in bringing about that change must be re-examined and re-shaped.

Unlike any of you, however, I have the unique responsibility for improving the lives and prospects of the poorest of America's poor. Across the Navajo Nation -- which is larger than the states of Connecticut, Delaware, Maryland, Massachusetts and Rhode Island combined -- our people live in conditions of economic deprivation virtually unknown in those states.

At a time when the average unemployment rate in America is 4%, the **unemployment rate in the Navajo Nation averages 38% to 50%**, depending on the season. Over 56% of the Navajo people live in poverty. Per capita income averages $4,106, less than 1/3 of that in the surrounding states. Only a very few Navajos enjoy certain "luxuries" that are taken for granted elsewhere in the United States -- 77% of Navajo homes lack plumbing, 72% lack kitchen facilities, and 76% lack telephone service. Though the Navajo Nation is slightly larger than West Virginia, our 2,000 miles of paved roads equate to barely 11% of West Virginia's 18,000 miles. Until recently, we had just three banking facilities within our entire 28,500 square mile area.

Ironically, the Navajo Nation is perceived as one of the more prosperous of Indian tribes. Tragically, these types of living conditions are mirrored at hundreds of other Indian reservations throughout the United States, with the nationwide Indian reservation unemployment rate averaging 56%. Not in the most destitute non-Indian rural areas, nor in the most decayed urban inner cites, nor in the Third World countries to which the United States generously provides foreign aid can the Members of this Committee observe chronic impoverishment and infrastructure shortfalls rivaling that found at Indian reservations in the states of:

Alabama	Iowa	Montana	Oregon
Alaska	Kansas	Nebraska	Rhode Island
Arizona	Louisiana	Nevada	South Dakota
California	Maine	New Mexico	Texas
Colorado	Massachusetts	New York	Utah
Connecticut	Michigan	North Carolina	Washington
Florida	Minnesota	North Dakota	Wisconsin
Idaho	Mississippi	Oklahoma	Wyoming

Listen to the words of several of your own colleagues, from both parties, who were among the bipartisan coalition that championed the Indian Investment and Employment Tax Incentives in 1993 (and who supported the more powerful IRITC):

Senator John McCain: "I challenge those Members who say they want to help the poor to remember the Indian people, perhaps the poorest members of our society."

Senator Pete Domenici: "American Indians are by far America's poorest ethnic group."

Senator Daniel Inouye: "The unemployment rate on the majority of Indian reservations is simply incomprehensible to the average American."

Representative Bill Richardson: "Nowhere -- I repeat nowhere -- in the United States can you find adverse economic conditions that rival those found consistently throughout Indian country."

And, as correctly summed-up by my predecessor, former President Peterson Zah:

> Stated simply, there is no single group of U.S. citizens that -- uniformly -- is more economically-deprived than American Indians living on reservations; there is no classifiable set of locations that -- uniformly -- is more deficient in infrastructure and job opportunities than Indian reservations.

INCENTIVES TO FACILITATE RESERVATION INVESTMENT AND CAPITAL FORMATION

The IRITC:

The IRITC is a powerful investment incentive for the private sector, and one that can truly influence business to consider Indian country for new or expanded investment. The Navajo Nation strongly recommends that, subject to a modification explained below, the Committee incorporate into its job creation legislation the identical IRITC that Congress enacted in 1992 in the vetoed H.R. 11, and that the Senate re-adopted in 1993 in its version of the Budget Reconciliation Act. See: (i) 1993 Senate-passed IRITC (139 CONG. REC. S8027-28 (daily ed. June 24, 1993)), (ii) excerpts from 1993 Budget Reconciliation Act Conference Report (H.R. REP. NO. 213, 103d Cong., 1st Sess. 718-23 (1993)), and (iii) excerpts from 1992 Conference Report on H.R. 11 (H.R. REP. NO. 1034, 102d Cong., 2d Sess. 45-49, 715-16, 721-23 (1992)) (submitted as exhibits).

Among the positive features of that twice-passed IRITC legislation are: (1) tax credits for Indian reservation personal property, new reservation construction property and, significantly, reservation infrastructure investment; (2) full credits available for qualified investments on all **reservations where Indian unemployment exceeds the national average by at least 300%**; (3) partial credits (1/2) on any reservations where Indian unemployment is between 150% and 300% of the national average; and (4) restrictions prohibiting availability of the credits for property used in connection with gaming activities. Significantly, the IRITC can encourage both small and large businesses, and promote both new investments and expansion of existing businesses.

The Navajo Nation recommends an important modification to the IRITC. The tax credit percentages previously acted upon by the Congress (i.e., 10% for reservation personal property, 15% for new construction property and 15% for infrastructure investment) should be made even more generous -- 20%, 25% and 25%, respectively. This is truly the type of powerful encouragement that will be required to help effectuate the reversal of decades of experience in which the private sector has virtually ignored Indian reservations as places to locate new investment and jobs.

Tribal Tax-Exempt Bond Financing: Although the Congress in recent years has cut back on the types/amount of tax-exempt bond financing that can be undertaken by state and local governments (including restrictions on issuance of private activity bonds), the limitations imposed on tribal issuance of tax-exempt bonds have been even more restrictive (in contrast to state and local governments) due to 1987 amendments to the Indian Tribal Governmental Tax Status Act of 1982. As a result, despite the fact that Indian reservations are the most disinvested, capital-poor locations anywhere in America, tax-exempt bond authority has had little, if any, positive impact in addressing those circumstances.

The 104th Congress should move dramatically not only to loosen those restrictions, but also to authorize expanded tribal tax-exempt bond issuance authority that can have an immediate effect in providing the capital -- for business formation and job creation -- that has been unavailable at Indian reservations historically. Toward that end, the Navajo Nation intends to forward shortly to the Committee legislative language that will allow this useful economic development tool to make a real difference on Indian reservations.

THIS INVESTMENT INCENTIVE AND CAPITAL FORMATION PACKAGE IS ESSENTIAL FOR INDIAN COUNTRY ECONOMIC DEVELOPMENT

While it would be convenient simply to dismiss these proposals by saying that it is too soon to create another set of federal tax incentives for Indian country, that response would be inappropriate, short-sighted and self-defeating. Indian country cannot afford to wait for ten years while Congress gauges the private sector's response to the accelerated depreciation incentive. To help resolve at last the extraordinary economic deprivation that has perpetually characterized Indian country and plagued the people who live there, nothing short of these meaningful and effective new incentives will suffice.

Indeed, the principal weakness of the Indian Investment and Employment Tax Incentives was the substitution, in conference, of the less-valuable accelerated depreciation incentive for the more-potent IRITC. That compromise resulted in an investment incentive that in all likelihood is not valuable enough, standing alone, to counter the inherent disincentives (primarily the lack of infrastructure) to Indian country investment. Adding a powerful new investment incentive to the existing accelerated depreciation incentive, however, will allow both to be used hand-in-hand as tools to attract the attention of a national business community that -- by reasons of unfamiliarity, misimpressions, misunderstanding or worse -- has been blind to the potential advantages of locating in Indian country. The IRITC will enhance the effectiveness of the accelerated depreciation incentive, not to mention the Indian employment credit, as an attractive draw to Indian country. (An added benefit is that the IRITC can be partially "paid for" to the extent of the savings from that portion of the value of property against which the credit is taken, and for which accelerated depreciation cannot be taken.)

One historic argument against an investment tax credit generally is that it provides benefits to investors for investments that would otherwise have been made even in the absence of the incentive. Of course, that argument fails miserably when applied to an IRITC targeted solely to Indian country and its 56% average unemployment rate.

As the Navajo Nation has repeatedly explained, Indian country is always at a significant disadvantage when competing -- even against the most financially-strapped non-Indian distressed communities -- for new private sector investment and jobs. This unlevel playing field that has perpetually confronted and confounded tribal economic development leaders is caused, most prominently, by the shocking lack of infrastructure that burdens reservation inhabitants everywhere. The increased non-wage business costs resulting from these unique infrastructure deficiencies can only be mitigated by availability of incentives that comprise or contain added benefits for Indian country in comparison to non-Indian areas (i.e., the so-called "Indian differential"). The proposed IRITC plainly meets this test.

That a powerful new incentive is needed cannot be subject to dispute. As explained above, the economic deprivation characteristic of Indian reservations and their inhabitants is unique within United States borders, and should be viewed -- with considerable alarm and discomfort -- as an embarrassment to all Americans. Rather than minimizing the scope of incentives targeted for encouragement of Indian country investment and jobs, a maximum, sustained effort should be directed -- not toward addressing, but actually to resolving -- this crisis for U.S. citizens living on reservations throughout America. The IRITC, when added to the accelerated depreciation incentive, can provide a powerful magnet to the private sector, and modification and enhancement of tribal authority to issue tax-exempt bonds can help bring about the capital formation to enhance the potential effectiveness of those investment (and the existing employment) incentives. NOW is the time to make the commitment to resolve the problem of Indian reservation unemployment and poverty.

Finally, the IRITC in particular is a perfect fit with the times. It is available directly to the private sector taxpayer, and is not dependent upon creation of a new government bureaucracy for implementation. Unlike appropriations, the IRITC can serve to leverage much higher amounts of private sector dollars flowing to reservations. Unlike the current expensing provisions under consideration (which are available only to small business), the IRITC can appeal to large and small business alike, and can serve to attract the focused attention of labor-intensive, factory-type facilities that to date have ignored Indian country. Unlike some other provisions currently on the table, the IRITC has twice enjoyed bipartisan support -- from the immediately preceding two prior Congresses. Today, the 104th Congress should at last make this twice-passed Indian country objective a reality, and should include expanded tax-exempt bond authority to enhance its potential.

CONCLUSION

Importantly, the IRITC is consistent with, and a tool that can effectively facilitate, "local empowerment." As I explained in my inaugural speech last month:

> The centerpiece of the Hale/Atcitty campaign, and now the Hale/Atcitty administration, is local empowerment. More than 52% of the Navajo voters endorsed local empowerment.
>
> * * *
>
> [L]et us release our people from the bondage of dependence by empowering them to decide for themselves and set the course and future for their communities and the Navajo Nation.

Mr. Chairman, nothing is more basic yet more essential to empowering people to lead successful, productive lives than having a job. Apart from the obvious economic benefits, having a job -- providing for a family and contributing to one's community -- empowers a person in untold psychological and spiritual ways that enrich and ennoble that person's life and the lives of their families.

If you are born an Indian, and you desire to remain on your reservation to live with your family and contribute to your community, you have less than a 50% chance of finding employment. This is a shameful, counterproductive set of circumstances that must be recognized immediately, addressed expeditiously, and resolved before the turn of the 20th century for the people who have inhabited this land for centuries past.

The IRITC and the enhanced tribal tax-exempt bond authority discussed herein properly look to the private sector to provide the investment dollars and job creation urgently needed throughout Indian country. These powerful incentives can work; half-way measures will not.

Passage of these measures can put this Committee in the forefront toward helping to correct the tragic circumstances of Indian reservation unemployment, poverty, infrastructure deficiencies and overall economic deprivation that scar the American landscape. On behalf of the Navajo Nation, I urge the Committee to make this issue one of your highest priorities as you mark-up the tax and job creation legislation.

February 2, 1995

* * *

February 3, 1995

HEARING BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

ON

THE PROPOSED NEUTRAL COST RECOVERY SYSTEM

WRITTEN STATEMENT
OF
PRICE WATERHOUSE LLP ON BEHALF OF A GROUP OF CLIENTS

Introduction

Price Waterhouse, on behalf of a group of companies from several industries, is pleased to submit this written statement concerning a proposal before the Congress to provide taxpayers with an alternative tax depreciation regime, called the Neutral Cost Recovery System (NCRS). NCRS is included as Title II of H.R. 9, the Job Creation and Wage Enhancement Act, and is a significant component of the "Contract with America."

Numerous commentators, including members of Congress, the Treasury Department, tax practitioner groups, trade associations, and others, have provided the Committee with their views on the political and policy ramifications of the proposal. The purpose of these comments is to address the basic technical issues of tax administration and compliance that we believe are of critical importance if a workable alternative cost recovery system is to be enacted.

Many commentators have suggested that the NCRS proposal is overly complex. Treasury Assistant Secretary for Tax Policy Les Samuels told the House Ways and Means Committee on January 10, 1995, for example, that the NCRS proposal would "add significant complexity to the tax system." Any depreciation proposal that provides taxpayers with an election to the current Modified Accelerated Cost Recovery System (MACRS) will inherently create additional calculations for taxpayers electing that system. It is our view that if the Committee determines to adopt the NCRS system, its complexity can be reduced and a workable system crafted that meets NCRS's stated goals.

NCRS as Introduced

The version of the NCRS included in H.R. 9 would permit taxpayers to elect, on an asset-by-asset basis, to apply a "neutral cost recovery system" to certain depreciable property. The goal of the NCRS proposal is to provide taxpayers with deductions, over the depreciable life of certain equipment, that approximate the asset's original cost in present-value terms. The proposal would be effective for property placed in service after 1994.

The section 168 depreciation schedule (MACRS) would be used as a base to calculate NCRS depreciation deductions, except that the 150-percent declining balance method would replace the 200-percent declining balance method. Depreciation deductions then would be increased to reflect (1) inflation occurring since the property was placed in service; and (2), in the case of property currently eligible for the 200-percent declining balance method (generally assets with MACRS regular tax lives of 10 years or less), an assumed 3.5-percent annual real rate of return. NCRS indexing for inflation would apply to "penalty" categories under section 168(g), such as property used abroad and property used by tax-exempt entities. NCRS would not apply to intangibles or other costs not recovered under section 168 (such as costs recovered under the income forecast method).

A taxpayer would be allowed to exclude property from NCRS. The election would be irrevocable. If no election were made, NCRS would apply for both regular tax and AMT purposes. An election to use NCRS solely for AMT but not for regular tax would not be permitted.

As compared to an earlier draft of the NCRS legislative language released in September 1994, the version included in H.R. 9 incorporates provisions that, we believe, would go a long way towards enhancing the depreciation system. These positive changes included:

- **Basis adjustment** -- The introduced bill would not require a basis adjustment for the NCRS benefit. Thus, the basis of an asset subject to NCRS could not be reduced below zero.

- **Recapture** -- Similar to the resolution of the basis adjustment issue, the portion of depreciation expense attributable to the NCRS benefit would not be subject to recapture.

- **Effective date** -- The original draft provided that the proposal would be effective for taxable years beginning after December 31, 1994. The introduced bill clarifies that the proposal would be effective for property placed in service after December 31, 1994, regardless of the taxpayer's year-end.

- **Designating assets subject to NCRS** -- The introduced bill would permit NCRS to be elected on an asset-by-asset basis.

- **Anti-churning rules** -- The bill includes anti-churning rules that utilize the anti-churning language included in the 1981 Tax Act as part of the enactment of ACRS.

- **NCRS flow-through in entities such as partnerships and S Corporations** -- In order to avoid a deviation of inside and outside basis, the NCRS benefit would not reduce basis for a pass-through entity.

- **Calculation of NCRS** -- The bill would use the GDP deflator rather than the GNP deflator as part of the NCRS calculation.

- **No ACE adjustment created** -- The bill includes an amendment to section 56(g) to prevent the creation of a new AMT ACE adjustment.

- **Coordination with luxury automobile depreciation rules** -- Language was included to clarify that the section 280F depreciation rules for luxury automobiles will continue to apply for NCRS property, and that the excess depreciation over the section 280F limitation would be available in later years.

Further Changes, Clarifications are Necessary

We believe that additional modifications to the legislative language, as well as clarifying committee report language, would make NCRS more "user friendly" and better satisfy its stated goals. Areas where particular attention should be paid include the actual calculation of NCRS, the application of NCRS for taxpayers that use special methods of depreciation, the application of the carryover basis rules, and the potential interaction of NCRS with other provisions of the Code.

- **Property depreciated using special methods**

Present law section 168(f)(1) provides that MACRS depreciation does not apply to property if the taxpayer has properly elected to depreciate the property using certain methods of depreciation, such as the income forecast method, the unit-of-production method, or any method not expressed in a term of years. In many cases, these methods can provide a superior measure of depreciation.

As currently drafted, the NCRS proposal would not apply for taxpayers using such methods of depreciation. The goal of the drafters to provide depreciation deductions that approximate the property's original cost in present-value terms should be extended to property where an election has been made under section 168(f)(1) to use a depreciation system that more closely approximates the economic depreciation of the property. Without this provision, property depreciated under section 168(f)(1) would be disadvantaged relative to property receiving the NCRS benefit. Loss of access to the NCRS concept should not be the price of adopting the alternative methods of cost recovery under section 168(f)(1).

- **Elective straight-line depreciation**

The Code allows taxpayers to elect the use of the straight-line method for property that would otherwise qualify for an accelerated (200 DB or 150 DB) depreciated method. However, section 168(k)(2)(B) of H.R. 9 would limit the neutral cost recovery ratio for such property to the change in the gross domestic product deflator, excluding the additional 3.5 percentage points per annum that would be allowed in the determinations of the ratio had the straight-line election not been made. The full amount of the ratio should be available in determining NCRS depreciation on property that would otherwise be eligible but for the straight-line election. This could be accomplished by excluding property subject to an election under section 168(b)(5) and 168(g)(7) from the special rule of section 168(k)(2)(B).

- **Carryover basis rules**

Property transferred in a non-recognition transaction described in sections 332, 351, 361, 371(a), 374(a), 721, or 731 (other than a section 708(b)(1)(B) transaction) takes with it a carryover basis. Thus, under the general MACRS rules, the transferee "steps into the shoes" of the transferor, and is treated as the transferor for purposes of computing the depreciation deduction with respect to so much of the basis in the hands of the transferee that does not exceed the adjusted basis in the hands of the transferor.

It would be appropriate to clarify the applicability of NCRS in transfers subject to section 168(i)(7). If NCRS applies to an asset in the hands of a transferor, that asset should retain its character as an NCRS asset to the extent the transferee "steps into the shoes" of the transferor. To the extent gain is recognized by the transferor, and the transferee is entitled to basis, NCRS should be available with respect to the additional basis.

- **Interaction with other code provisions**

There are several instances in which the NCRS legislative language should be clarified in order to ensure proper interaction with other Code provisions so that the intent of NCRS to provide a present-value equivalent of expensing is preserved.

First, the calculation of taxable income for <u>limitation purposes</u> should not include the NCRS benefit. In situations where taxable income limits the amount of an available deduction, the

NCRS benefit can be partially or completely eliminated through the operation of a taxable income limitation that includes the full amount of the depreciation deduction.

For example, percentage depletion under section 613 is limited to 50 percent (100 percent for oil and gas properties) of the taxable income from the mineral property. If taxable income from the property is reduced by the additional depreciation allowed as a result of the NCRS system (the NCRS benefit), the percentage depletion deduction will be reduced by one-half of the amount of the NCRS benefit in the case of most minerals, and by the full amount of the NCRS benefit in the case of oil and gas. Thus, an independent producer of oil and gas whose depletion deductions are limited by the taxable income of the property will receive no benefit from the NCRS system since every additional dollar of NCRS depreciation will reduce the depletion deduction by that same dollar. Similarly situated producers of other minerals would lose one-half of any additional NCRS depreciation.

A second issue arises in the application of the at-risk rules to activities that include NCRS depreciation. The additional NCRS depreciation deduction should not be taken into account in determining the amount a taxpayer is considered to have at-risk with regard to an activity. Otherwise, where the at-risk limitations limit the amount of deductions otherwise available, the additional NCRS depreciation deductions will have no effect. Similar to the application of the net income limitation, each dollar of additional NCRS depreciation would be eliminated through a reduction by the same dollar in the at-risk limitation.

A third issue is the calculation of the basis in the stock of a consolidated group member under section 1503(d). The bill should provide that additional NCRS depreciation will not reduce basis in such stock, just as the bill currently provides that the additional NCRS depreciation does not reduce the basis in a pass-through entity.

- **Availability of MACRS elections**

Under the general MACRS rules, assets are depreciated on an item-by-item basis. Taxpayers may elect to depreciate property using a general asset account. Under this method, a group of assets, identified by the taxpayer, are depreciated as one asset. Proceeds realized on the disposition of an asset from the group are included in income, without a reduction for the basis of the asset. Taxpayers are permitted to elect to depreciate property subject to MACRS using the straight-line method over either the recovery period or the class life of the asset, whether using term accounts or group accounts.

NCRS committee report language should specify that all elections available under MACRS are also available under NCRS. Thus, the election to apply general asset accounting to a specified group of assets would be available under NCRS. In addition, the designation of a class as subject to NCRS would be sufficient to designate all of the assets in that class as subject to the general asset account. However, an election to depreciate property using the straight-line method of accounting would subject the property to the limitations in proposed section 168(k)(2)(B).

- **NCRS calculation should be simplified**

H.R. 9 as introduced requires the calculation of a separate NCRS ratio for every calendar quarter in which property is placed in service. The NCRS calculation could be simplified by using a single NCRS ratio for all additions occurring during a year. Such a change could be accomplished with a minimal loss of accuracy and benefit to the taxpayer.

Under H.R. 9, the NCRS ratio is determined by comparing the GDP deflator for the end of the calendar quarter the property was placed in service with the GDP deflator for the corresponding calendar quarter of the current taxable year. Thus, a full year of inflation is accounted for in determining the NCRS depreciation deduction for the second year. One would determine which 12 months of inflation to count by looking to the quarter the property is placed in service.

A simpler alternative would be to compare the GDP deflator for the mid-point (June 30th) of the calendar year the property was placed in service with the corresponding mid-point of the current calendar year. This would allow the same NCRS ratio to apply to all property placed in service during a calendar year and reduce by 75 percent the number of ratios required to be kept by most taxpayers. A full year of inflation adjustment would still be allowed for each year the property has been in service.

Such a method would permit the IRS to calculate and publish the ratio for any calendar year in time for inclusion in tax forms and instructions, in addition to simplifying taxpayer compliance.

Conclusion

We appreciate the opportunity to comment on the basic technical and administrative aspects of the NCRS proposal. As the Committee continues its work on NCRS and other alternatives for improving capital cost recovery under the tax system, we look forward to the opportunity to continue this important dialogue.

This statement has been filed with the House Committee on Ways and Means on behalf of the following companies:

Anheuser-Busch Companies, Inc.
Caterpillar, Inc.
Dresser Industries
Goodyear Tire & Rubber Company
Praxair

Price Waterhouse LLP

Price Waterhouse LLP
February 3, 1995

Testimony of Congressman F. James Sensenbrenner
H.R. 89, "Family Farm Tax Relief and Savings Act of 1995"
Ways and Means Committee
January 31, 1995

I have introduced H.R. 89, the "Family Farm Tax Relief and Savings Act of 1995," to assist farmers in planning for retirement. This legislation would allow qualified farmers to rollover the gain from the sale of farm assets into an Individual Retirement Account.

Operating a farm is a unique and highly capital intensive business. Most American farmers must reinvest profits and excess capital into their farm in order to maintain productivity. The substantial capital commitment precludes many farmers from participating in traditional retirement accounts, such as an IRA or Keogh. For many farmers, the investments that are made in farm assets will be sold at a later date as the primary means of financing retirement.

The unpredictability of farm income also creates a serious problem for farmers planning for retirement. During difficult years, farmers may not have money to invest. By contrast, a very successful year may provide farmers with substantial profits that may be invested for retirement. However, current retirement savings accounts place a limit on the amount of money that may be invested with a tax advantage. These limits preclude farmers from maximizing their retirement savings when it becomes available.

H.R. 89 addresses the special retirement needs of farmers by allowing them to invest the <u>gain</u> of the sale of farm assets into an Asset Rollover Account (ARA). The ARA increases the amount of money that a qualified farmer may invest for retirement with deferred taxation similar to an Individual Retirement Account. By investing in an ARA, farmers may defer taxes on up to $500,000 in capital gains from the sale of farm assets for retirement. Annual contributions shall not exceed the year's qualified net farm capital gain or the number of years an individual has been farming multiplied by $10,000. The initial rollover of funds from a prior savings or retirement account into an ARA will not be subject to the annual limits.

For purposes of the ARA, a qualified farmer must have actively participated in the business of farming during the five years prior to the disposition of the farm assets. In addition, the farmer or spouse must have owned at least 50 percent of the farm during that time.

The ARA established by H.R. 89 accommodates the unique retirement needs of farmers. It allows them to make large investments for their retirement when money is available. This is usually after the sale of farm assets such as land and equipment that occupy the majority of a farmer's capital. This legislation gives farmers the opportunity to participate in the same tax deferred retirement investment used by millions of Americans in other professions.

In addition, this legislation will promote the continuance of family farming by eliminating the capital gains tax burden that often keeps a farmer from selling a farm to the next generation. Under current law, farmers have an incentive to maintain ownership of the farm until death, leaving their heirs with the tax burden of inheritance. H.R. 89 would encourage the sale of a farm upon retirement by allowing a farmer to defer the tax.

As the Members of the Ways and Means Committee consider the many worthwhile savings and investment provisions included in the American Dream Restoration Act, I hope that they will give special consideration to the savings and retirement needs of America's farmers. I encourage the members to incorporate H.R. 89, the "Family Farm Tax Relief and Savings Act of 1995," in their markup of the American Dream Restoration Act. I have requested an estimate of the revenue implications of H.R. 89 from the Joint Committee on Taxation. I will share that information with the Ways and Means Committee members when it becomes available.

Statement of
James L. Martin, Chairman
The 60/Plus Association
1655 N. Fort Myer Dr., #700
Arlington, VA 22209 (703) 351-5251

Committee on Ways and Means
United States House of Representatives

The Job Creation and Wage Enhancement Act (HR 9)
Estate Tax Reform and Senior citizens

February 1, 1995

INTRODUCTION

Mr. Chairman and Members of the Committee, my name is Jim Martin and I'm the Chairman of The 60/Plus Association. I'm here today to lend support to the Job Creation and Wage Enhancement Act (HR 9), especially the capital gains cuts, but specifically the Federal Estate and Gift Tax provisions contained therein.

Late last year when the details of the Contract with America were available, 60/Plus was extremely pleased to see the Estate Tax provisions calling for an increase by 1998 to $750,000 from the current $600,000 exemption, a figure that hasn't been raised in 14 years.

We at 60/Plus had, in fact, fought steadfastly for two years against a tax-and-spend philosophy which called for lowering, not raising, this exemption, to $200,000. The legislation, fortunately, has made no headway in either the House or the Senate.

While 60/Plus favors other legislative proposals that either double the $600,000 exemption to $1.2 million, or eliminate Estate Taxes altogether, we realize that "one small step for mankind" is better than no step at all.

And we appreciate the willingness of this Committee and particularly of this Chairman to commit to the task of achieving that first important step.

All seniors and their children and grandchildren applaud you for your efforts.

60/Plus is in its second year of active operation, with a membership of over 225,000. We publish a newsletter, the *Senior Voice*, which regularly features the popular "Lawmaker of the Month" column. Also, 60/Plus is the only conservative senior citizens group to publish a Rating System, scoring Members of Congress based on their pro-senior votes. If any Member of Congress scores 60 percent or better (60/Plus) on the Scorecard that Member receives the "GUARDIAN OF SENIORS' RIGHTS AWARD." In the 103rd Congress, 226 Members, Republicans and Democrats alike in the House and Senate, received our non-partisan award.

60/Plus is an anti-tax advocacy group dedicated to repealing the Federal Estate and Gift Tax, an unfair tax placed upon senior citizens and their heirs. Specifically, we're working with several Members of Congress as well as many small family-owned businesses, and others concerned that the Estate Tax, otherwise known as the "Death Tax," is unfair, burdensome and a job killer.

IN THE BEGINNING...

A little background on the Federal Estate and Gift Tax should be of some interest to you, because "temporary" levies all too often become permanent.

The first Federal Estate Tax was enacted in the 1860s, during the Civil War when money was needed to finance the war effort. Once its purpose was served, however, this temporary tax was repealed in 1870.

In 1898, yet-another temporary Estate Tax was approved. This Estate Tax was imposed to meet the budgetary needs caused by the outbreak of the Spanish-American War. Again, this literal temporary tax also was repealed in 1902 just four years after it was imposed.

The first Estate Tax to become permanent was enacted some 14 years after the repeal of the Spanish-American War temp-tax. This long-term Estate Tax was included in the Revenue Act of 1916, which saw the initiation of a permanent income tax. And estate planning hasn't been the same since.

SOCIAL CONSEQUENCES

60/Plus believes, as do most on this Committee, that when taxes are cut, government revenue *increases*. Why is this the case? Taxes alter how hard people work. Government revenue estimators continue to ignore the evidence that when taxes are raised, businesses don't hire, they fire. Government revenues decrease. However, when the tax burden is lifted, people invest, work harder and save more money. At the same time, businesses hire more people, invest more money, take more risks, expand operations and, thus, pay more taxes.

Expecting to raise $40 billion in new revenue, (by raising the top rate of tax by more than one third, from 31% to 42%), the Clinton tax increase will in our estimation have a devastating impact on revenue the government is counting on. One noted economist says the tax increase will yield only $10 billion, or only 25 percent of projections.

Another example given by Bruce Bartlett, former Executive Director of the Joint Economic Committee, shows a 1979 Joint Committee on Taxation (JCT) forecast of revenue gained by the Crude Oil Profit Tax. The JCT estimated raising $184.5 billion between 1980 and 1985. The tax raised only $77.7 billion, less than half of the government projections.

This gets back to the social consequences. Tax policy has consequences on everyday people and businesses. How they think, how they operate, and how they invest is oftentimes determined by Washington's taxes.

When taxes punish lifelong habits of thrift, when taxes discourage entrepreneurship, when taxes penalize families, when taxes are applied to already-taxed income, then they are wrong, immoral and, most of all, unfair. This is exactly the case with the most confiscatory tax of all, the Inheritance Tax and I might add, all Social Security taxes, the earnings limit placed on senior citizens.

Despite the fact that the $600,000 tax exemption has not been adjusted for inflation in recent years, and thus is being taxed even more heavily than it was a decade ago, there are some lawmakers who believe the exemption is too generous. They want even more of our estates to go into federal hands.

A leader in this bid to cut even deeper into the estate you wish to pass along to your loved ones, or perhaps to some favored charitable institution, introduced a long-term health care bill which would not only ignore the lack of inflation adjustment, but would practically abandon any such adjustment. The proposal was to lower the $600,000 tax exemption to an unbelievably low rate of $200,000.

Under this scheme, some portion of your estate over $200,000 in value that you leave to your heirs would be taken from them and funneled into the federal coffers.

Our Honorary Chairman at 60/Plus, Former Rep. Roger Zion (R-Ind.), put it quite succinctly. The Indiana Republican said, "Imagine losing up to 55% of everything you've worked so hard to acquire to the government. It's even more frightening when you consider that you'll be taxed for dying on assets on which you've already paid a hefty tax."

Fortunately, several Members of Congress fought successfully to block passage of this rip-off.

SENIOR CITIZENS OVERWHELMINGLY SUPPORT REFORM

In a random sample of 7,359 respondents to the 60/Plus 1995 Seniors' Legislation Issues Survey, 60/Plus members overwhelmingly rejected the Federal Estate and Gift Tax.

Our members are telling us we're right on target in our efforts to get the federal government out of seniors' pocketbooks. Question 1 of the survey was, "The Federal Estate tax exemption on assets has been $600,000 since 1981. House Appropriations Committee Chairman Bob Livingston (R-La.) introduced legislation that would double the exemption to $1.2 million. Do you want Congress to increase the exemption? Seventy-seven percent of seniors said yes.

The second question was, "Besides the proposal to double the exemption, Rep. Chris Cox (R-Calif.) has also introduced legislation to repeal Federal Estate and Gift Taxes altogether. Do you agree with Rep. Cox's bill? Seventy-nine percent of senior citizens agree that the Federal Estate and Gift Tax should be done away with!

60/Plus reiterates its support for the Job Creation and Wage Enhancement Act (HR 9). We think it is a good first step forward, especially its eventual Estate Tax exemption increase to $750,000 from the current $600,000.

However, we will continue to advocate proposals that go even further. And, with that in mind, I submit for the record a recent column, "A 'Job-Robbing' Double Tax on Seniors and their Heirs," which was distributed to more than 200 seniors' publications nationally.

I look forward to working with the Committee on behalf of 60/Plus, which represents a rapidly growing seniors population who've already made sacrifices and contributions to the safety, prosperity and security of our nation.

Thank you.

New England Senior Beacon, Milford, NH

8-Senior Beacon - January 1995

A "Job-Robbing" double tax on seniors and their heirs

By James L. Martin
Chairman, 60/PLUS

Most of you are probably familiar with the T.V. quiz show, "Jeopardy," where contestants are given an "answer" for which they must reply with the correct "question." Let's try our hand at a "Jeopardy" sample: The "answer" is: "The Inheritance Tax." The correct "questions": "What is the Grave-Robber Tax?"

Although the Inheritance Tax is called by several different names,—Estate, Gift, and Generation-Skipping Transfer Taxes—I prefer to call it as I see it, as the Grave-Robber Tax. It's a tax levied on estates that already have been subjected to virtually all other taxes as they were built over the years. Inheritance Taxes are double, even triple, taxation. Yet, the plain truth is: Inheritance Taxes, despite what their congressional advocates may claim, are a minimal source of revenue. In fact, they well may add to the federal financial problems by decreasing jobs, wages and output.

They account for an average of only about 1% of the total annual federal revenues year in and year out. Enormous amounts are spent in collecting and administering these taxes; and in lawyers' and accountants' time and expense as people try to avoid this punitive tax.

The facts show that Inheritance Taxes reduce the revenue from other taxes, by causing lower employment, lower wages, and lower production output. These taxes are revenue decreases, not revenue raisers.

In order to pay Inheritance Taxes, heirs must often sell the family business. Nine out of 10 cite the Inheritance Tax as the primary reason they must sell. Then, when the new owners frequently fail, jobs are lost.

The Inheritance Tax affects America's seniors, their heirs, and family-owned business of all sizes.

A joint study by the Center for the Study of Taxation and the Institute for Research on the Economics of Taxation shows that, if Inheritance Taxes had been eliminated in 1971, the following would have resulted by 1991; the nation's gross domestic product (GDP) would have been $46.3 billion higher than it was; 262,000 full-time jobs would have been created; and the stock of capital would have been $398.6 billion greater than the actual amounts for that year.

The study further projected the following would have occurred by the year 2000; the GDP would have been $79.22 billion higher; 228,000 more people would have been employed; and the amount of savings and capital would have been $630 billion higher than the amount projected under current tax law.

In the last session of Congress, Rep. Chris Cox (R-Calif.) introduced The Family Heritage Preservation Act (H.R. 2717) that would eliminate the federal estate and gift taxes and the tax on generation-skipping transfers.

Cox titled it the "Family Heritage Preservation Act" because of its focus on the social consequences of Inheritance Taxes.

Under the Inheritance Tax seniors, their heirs, and family-run small businesses are struck a devastating blow in the form of a 37% to 55% (Clinton raised it to 55%) tax on their after-tax savings. This is not just wrong, it's extremely unfair and ill-conceived.

Even though there is an exemption from this unfair tax on the first $600,000 of your estate, soon to be raised to $750,000 in the new Congress, 60/PLUS feels Inheritance Taxes must be totally repealed in the interests of fairness and for the good of society.

Inheritance Taxes discourage savings, discourage entrepreneurial enterprises, and penalize families. They are anti-family.

Their waste and economic inefficiency is apparent when you realize the thousands of lawyers and accountants who must be paid billions of dollars each year just to help individuals and family-owned businesses deal with the impending loss of their after-tax savings.

The Inheritance Tax caused businesses to close down, thus increasing unemployment, and they generally restrain businesses from operating and competing in an open marketplace.

And, for every "Rockerfeller" or other "wealthy" individual who some feel should have to "pay" this extra tax, we, at 60/PLUS, say two things: First, these individuals have already paid their taxes duly and properly; and second, for every "Rockefeller" hit by this double tax there are thousands of mom and pop-run businesses and small farms in each of the 50 states who are literally "run out of business" by this unjust tax.

Going back to our "Jeopardy" session, the answer is: "Repeal it." and the question? "What should we do about the Inheritance Tax?"

Editor's Note: The 60/PLUS Association is located in Arlington, Va., and is a two-year-old seniors advocacy group with a free enterprise, less government, less taxes approach to issues, with 225,000+ supporters nationally.

WRITTEN STATEMENT OF
THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE COMMITTEE ON WAYS AND MEANS
OF THE UNITED STATES HOUSE OF REPRESENTATIVES

ON ESTATE, GIFT AND GENERATION-SKIPPING TAX REFORM

JANUARY 31, 1995

SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans, and employ over 1,500,000 employees.

The time has come for Congress to repeal the estate, gift and generation-skipping taxes.

An estate tax due nine months after death is imposed on the transfer to children or other heirs of the taxable estate of every decedent who is a citizen or resident of the United States ($600,000 of assets are exempt). The graduated estate tax rates begin effectively at 37% and increase to a maximum rate of 55% (see Exhibit "A" for how the tax is calculated). Taxes on bequests to spouses may be deferred until the last-to-die of husband and wife.

A gift tax is levied on taxable gifts (excluding $10,000 per donee per year) as a back-stop to the estate taxes. The graduate rates are the same. (The $600,000 exempt amount may be used during life for gifts or at death.)

An extra, flat 55% generation-skipping tax is imposed on gifts or bequests to grandchildren ($1,000,000 is exempt).

The 1986 White House Conference on Small Business recommended eliminating estate and gift taxes on the transfer of small business assets to family members. Legislation has been introduced in prior years to accomplish this (Exhibit "B" attached).

With a new entrepreneurial voter wave shifting control of both the House and Senate to Republicans, it is time to repeal these transfer taxes. President Clinton has expressed the desire to retain and increase jobs. Repeal would do this!

- Only 30% of family business make it through the second generation. Seventy percent (70%) do not. Only 13% make it through the third generation. Eighty-seven (87%) do not. The primary cause of the demise of family businesses, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)

- A recent study by Prince and Associates (research company) for National Life of Vermont reviewed the history of 749 family businesses which failed within three years after the death of the founder. The Prince study reinforced and supported the conclusion of the deadly effect of estate taxes. The businesses could not continue as a result of the tax drain on working capital needed to effectively compete and cover errors in judgment made by new and younger management. Jobs were lost in the communities.

- The estate tax took its present form primarily in the early 30's. The express purpose was to "break-up wealth". Is this consistent with a free enterprise economic system and a very competitive world economy? In 1992, the estate, gift and generation-skipping taxes accounted for only 1.1% of revenue. The expense of administering this system probably offset 75% or more of the revenue.

- The transfer tax provisions represent 82 pages of the Internal Revenue Code and 289 pages of Regulations issued by the Internal Revenue. The transfer tax system forces many estates, the Internal Revenue Service, and the Department of Justice to expend funds in court. The number of transfer tax cases now total 10,247 representing some 13,050 pages of the Commerce Clearing House Tax Publication.

- Australia repealed their estate and gift tax laws in the mid-1970's. It was felt that these transfer taxes were an inhibitor on the growth of family businesses. The legislative body of Australia sought more jobs which they believed would come if family businesses grew larger and were not caused to sell, downsize, or liquidate at the death of the founder to pay estate taxes.

  The President has expressed concern about children inheriting appreciated assets from deceased parents and selling them without paying income taxes on the profits. This is the result of the step-up in basis to the value as shown in the estate tax return. If the transfer tax laws were repealed, there would be no step-up in basis. At the time assets were sold, gain would be taxed and funds available to pay the tax. The fair market value of assets sold would be fixed. To make this law equitable with existing law, there would be a step-up in basis for the first $600,000 of assets.

- If you factor the significant expense in collecting these taxes and the income tax when assets were sold, the repeal may be revenue neutral.

- Combined income and estate taxes frequently consume 75% or better of retirement plan accounts at death (see chart attached as Exhibit "C").

Even if transfer taxes cannot be repealed there are a number of steps Congress could take right now which would substantially alleviate the problems faced by small business owners. **A major first step is that taken in the Contract With America - increase the $600,000 deduction limit to $750,000. This is a major improvement over the present system and one that would be appreciated by small business owners across the country. We submit that this increase, however, should be indexed with the cost of living so that it remains a meaningful number.** Some commentators suggest that if the $600,000 had been indexed, it would be in the million dollar range now. That would make a significant difference. **Here are some other changes that would help small business owners:**

- **Eliminate the extraordinarily complex generation-skipping tax or increase the exemption from $1,000,000 to $5,000,000;**

- **Change the so-called 5-5 power to a 5-10 power to keep it in line with other areas of the transfer tax law;**

- **Reduce the estate tax rates - they are all too high, but 55% is just way too high. One way to accomplish this is to expand the estate tax brackets to take into account inflation since the brackets were established.**

Some of our most wealthy citizens have elected to give up their citizenship, become citizens of foreign countries, and avoid the 55% transfer taxes. The cover story of Forbes, November 21, 1994 was devoted to "Expatriation -- As the Ultimate Estate Planning Technique." What a loss of available capital!

This statement was largely prepared by Harold I. Apolinsky, Past Chair of the Small Business Council of America (SBCA) and currently Vice President of Legislation. He is a practicing tax attorney (over 30 years) who specializes in estate planning and probate. For over 18 years, he has taught estate planning and estate, gift and generation-skipping taxation to law school seniors at both the University of Alabama School of Law in Tuscaloosa, Alabama and the Cumberland School of Law in Birmingham, Alabama. This testimony is contrary to the best interest of the author's tax practice, his teaching, and his firm (they have 6 lawyers out of 94 doing estate planning, administration and probate) to urge repeal of these transfer taxes. He strongly believes, however, that it is the right thing to do to help grow family businesses, provide jobs and encourage the entrepreneurial spirit needed for small businesses to become large businesses.

EXHIBIT "A"

CALCULATION OF ESTATE TAXES

A. Gross Estate (fair market value at death of all assets, including real estate, stock, cash, life insurance, retirement accounts, etc.).

B. Deductions:

1. Debts and expenses.

2. Marital (assets left to spouse if citizen).

3. Charitable.

C. Taxable Estate.

D. Add Prior Taxable Gifts.

E. Total transfer to heirs (life and death).

F. Apply Rates: 18% to 55%.

G. Less credit ($192,800)*

H. Net tax (effective 37% to 55% [plus 5% for larger estates] due 9 months after death.

* *This is tax on $600,000 taxable estate.*

EXHIBIT "B"

PERTINENT LEGISLATION

A. Legislation was introduced in July 1993 (H.R. 2717) to repeal estate, gift and generation-skipping taxes.

B. Legislation was also introduced but not enacted in the 102nd Congress which would have allowed heirs of small business owners to defer the estate tax owed on a farm or business until it was sold outside the family. In order to take advantage of this deferral, the following requirements would have to be met:

(1) The business must be worth less than $50 million.

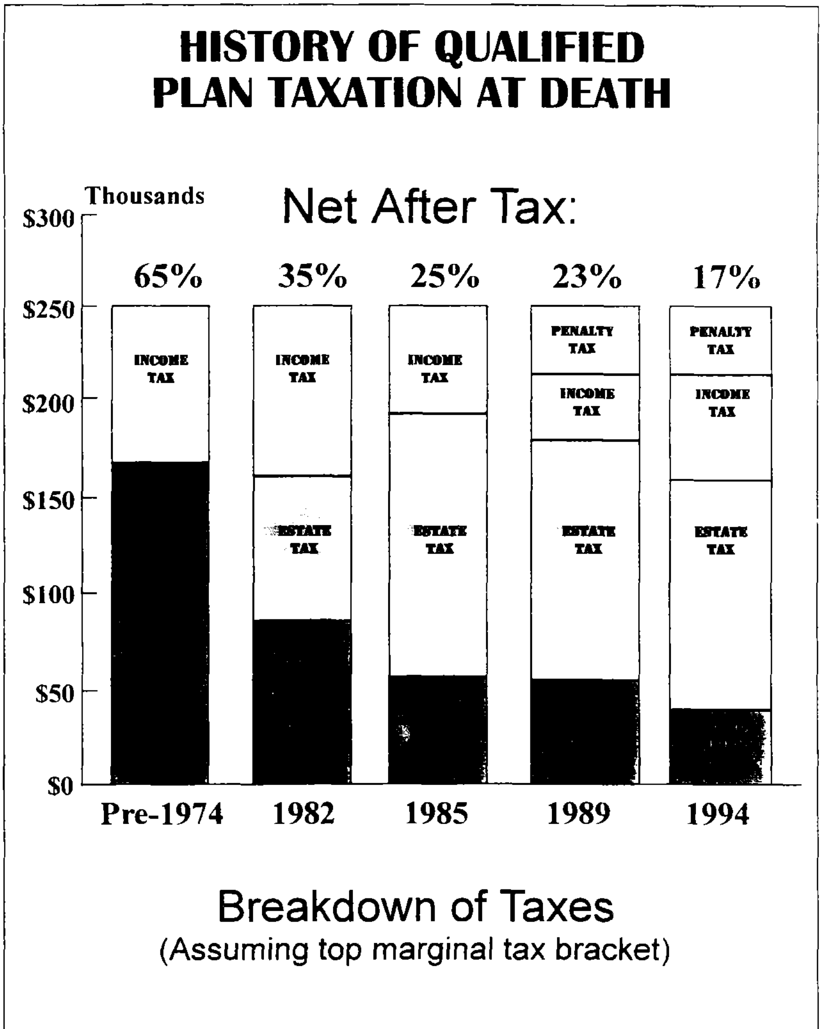
(2) The business must comprise at least 40 percent of the decedent's estate.

(3) The person inheriting the business must have actively participated in the running of the business prior to the owner's death.

C. A provision in separate legislation also introduced in the 102nd Congress would have reduced the amount exempt from estate and gift taxes from $600,000 to $200,000. This provision of the bill was subsequently withdrawn.

D. Legislation introduced in the 103rd Congress included bills that would increase the estate and gift tax exemption to $770,000 plus cost-of-living adjustments (H.R. 567), $850,000 plus cost-of-living adjustments (H.R. 1475), $1 million (S. 531) and $1.2 million (H.R. 1110).

EXHIBIT "C"


HISTORY OF QUALIFIED
PLAN TAXATION AT DEATH
Thousands
Net After Tax:
$300
$250
$200
$150
$100
$50
$0
65%
35%
25%
23%
17%
PENALTY TAX
INCOME TAX
ESTATE TAX
Pre-1974
1982
1985
1989
1994
Breakdown of Taxes
(Assuming top marginal tax bracket)

STATEMENT
of
TELEPHONE AND DATA SYSTEMS, INC.
before the
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
regarding the
NEUTRAL COST RECOVERY SYSTEM
proposal of the
JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995 (H.R. 9)
February 3, 1995

This statement is being submitted by Ross J. McVey, Assistant Controller, Telephone and Data Systems, Inc., P. O. Box 628010, Middleton, Wisconsin 53562-8010 (608-828-8314). Telephone and Data Systems, Inc. ("TDS"), is pleased to have this opportunity to submit this statement to the Committee on Ways and Means concerning select tax provisions contained in the Contract With America (the "Contract"). TDS is one of the largest independent communications providers in America, employing over 4,700 people in 45 states through its telephone, cellular, and paging operations. The communications industry has and will continue to play a major role in the economy of this country. This is a highly capital-intensive industry, one which consistently advocates federal tax policies that lower the cost of capital and provide needed incentives to implement new technologies.

TDS supports the underlying precepts of the Contract, those being the lessening of the role of government through lower taxes, less spending, and the promotion of jobs and the economy through capital formation. To that end, we have focused our comments on the following two Contract proposals within the Committee's jurisdiction which are of primary importance to TDS, its employees, and its customers: The Neutral Cost Recovery System and the Capital Gains Exclusion.

TDS is aware that the United States Telephone Association ("USTA"), an organization of which it is a member, is filing similar comments on these topics. We have participated in the development of those thoughts and are in full agreement with them.

NEUTRAL COST RECOVERY

The Neutral Cost Recovery System ("NCRS") contained in the Contract contains many positive aspects that will help achieve the desired goal of capital formation. The increase of depreciation deductions to reflect the effects of inflation and the time value of money coupled with not reducing the tax basis of the subject property by the indexed factors will depreciate the property in a manner that more accurately reflects a company's true economic investment.

TDS supports the extension of NCRS to the depreciation component of the alternative minimum tax ("AMT"). The failure to do so would destroy the parallel nature of the regular and AMT tax systems and would accelerate the cash flow requirements of AMT taxpayers, offsetting the incentives of NCRS.

For taxpayers subject to regulation, such as our telephone operations, the benefits of NCRS must be normalized. This is especially true due to the back-loaded benefits of NCRS. Otherwise, the intended benefits may not accrue to the taxpayer. Rather, regulators may pass the benefits on to ratepayers immediately rather than over the life of the property.

A concern of TDS with NCRS, as presently structured, is that the provisions do not evenly apply to certain industries and property. The proposal's 3.5 percent time-value-of-money adjustment would only apply to property with a class life of 10 years or less. This could have the effect of discouraging investment in long-lived property, which can account for up to 35 percent of the annual investment made by TDS and other telephone companies. Failure to include long-lived property, as eligible for the 3.5 percent adjustment, could also cause some unintended distortions in competitive behavior.

As noted above, a significant portion of TDS's investment is in long-lived property. The different treatment accorded long-lived property is unequitable in that many of the current and future competitors of telephone companies are permitted to recover their investments in the same type of property over seven years versus the 15 years required for telephone companies.

With regard to applying the provisions, we support the flexibility of allowing the NCRS election to be made on a property-by-property basis. We do feel the election to utilize NCRS should be affirmative, rather than requiring an election to decline, as currently drafted. Additionally, the requirement of applying the indexes on a quarterly basis will add cost and time to comply with these rules. The use of an annual index would provide for ease in compliance and still achieve the objectives of the legislation.

CAPITAL GAINS

TDS is a strong proponent of the proposed 50 percent exclusion of capital gains, as well as the indexing of capital gains for inflation. Investors and businesses should be taxed only on real economic gains resulting from their capital assets and not on inflationary gains. The proposed exclusion and inflation adjustment allow investors to retain more of their investment, lowering the cost of such capital. This affect of both provisions is multiplied in that they would encourage greater investment in the new technologies needed to allow our economy to compete in today's global markets.

The concern over the requirement of using a quarterly index as stated above for NCRS is applicable here also. This provision would be burdensome for the typical investor.

FEDERAL REGULATIONS

We would like to express and encourage caution in considering the impact of a proposed moratorium on federal regulations. Specifically, we would ask that, in the event this is considered, there be an exemption for tax regulations published by the Treasury Department. These regulations are needed to provide taxpayers a semblance of confidence in dealing with the complexities of the tax law. A moratorium would likely have the effect of increasing individual letter rulings, taxing an already overburdened Treasury staff.

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We would like to congratulate the authors of the Contract for their boldness and vision in seeing the true needs of this economy, and the need to spur capital investment. TDS, as a communications player on the "Information Superhighway", realizes the need for the investment upgrades, and would encourage your efforts in proposing tax legislation to that end.

Thank you for this opportunity to present testimony. We would be pleased to discuss these items with members and committee staffs at their convenience.

STATEMENT OF W.M. GRIFFIN
VICE PRESIDENT, GOVERNMENTAL AFFAIRS
TEXAS UTILITIES CO.

Texas Utilities Company ("Company") submits this written statement to the House Committee on Ways and Means in support of the provisions of the Neutral Cost Recovery System ("NCRS") of H.R. 9, the Job Creation and Wage Enhancement Act, and in support of proposals to modify the alternative minimum tax ("AMT").

The Company is a diversified holding company. The Company has a wholly-owned subsidiary, Texas Utilities Electric Company ("TU Electric"), which is engaged in the operation of an electric public utility system involving the generation, transmission, distribution and sale of electric energy in Texas.

BACKGROUND

The Company supports the NCRS for the reasons set forth in the testimony before this Committee by John McCallum on behalf of the Potomac Electric Power Company and the Edison Electric Institute on January 26, 1995. However, as discussed in the testimony of numerous witnesses, including Mr. McCallum and Paul R. Huard on behalf of the National Association of Manufacturers, the Company believes that the Committee should consider legislation to remedy some of the inequities and unfair policy inherent in the current structure of the AMT.

PROPOSAL

Under current law, AMT liability is a credit that generally may be carried forward to reduce regular tax liability, but not to reduce AMT liability. The Company believes that, in order to promote both fundamental fairness and national economic policy objectives, Congress should modify the AMT to permit a taxpayer to utilize its total accumulated AMT credit carryforwards to reduce its AMT liability. The amount of accumulated AMT credits as of December 31, 1994 would be usable against AMT liability ratably over five years (i.e., 20 percent of the total amount would be usable against AMT for each of the years 1995 through 1999). For any taxable year after 1994, a similar 5-year amortization convention would be applicable. In any year in which there is regular tax liability, the accumulated AMT credits also would be usable as under current law.

In addition, the Company believes that the Committee should consider conforming the AMT depreciation rules to the regular tax depreciation rules on a prospective basis.

REASONS FOR THE CHANGE

1. Purpose of the AMT

The current AMT was originally enacted as part of the Tax Reform Act of 1986 to ensure that taxpayers having economic profit reported taxable income and paid Federal income tax. The AMT is a comprehensive, separate tax system, but parallel to the regular tax system. It was designed to ensure that profitable taxpayers do not minimize (or avoid altogether) Federal income tax by employing legitimate tax rules.

2. Unfair Impact of the Current AMT

In practice, the AMT has served to discriminate against taxpayers in capital-intensive industries. This discrimination results primarily because the depreciation rules used in computing the AMT are considerably less favorable than the depreciation rules used for regular tax purposes. In other words, the AMT depreciable lives are longer, and the AMT depreciation methods are less accelerated, when compared to the regular tax depreciable lives and depreciation methods. Thus, in practice, the AMT, as applied to capital-intensive taxpayers serves as depreciation "penalty."

Congress has already recognized the inequity of the AMT as it applies to capital-intensive industries. In the Revenue Reconciliation Act of 1993, Congress amended the provisions governing the AMT to eliminate the depreciation component of the adjustment for current earnings (the "ACE adjustment"). While this change has had the effect of partially reducing the unfair impact of the AMT upon capital-intensive taxpayers, the relief that the amendment provides is limited because it applies only to property placed in service after December 31, 1993. Thus, the amendment does not serve to relieve the problem for taxpayers that made substantial capital investments that were placed in service on or before December 31, 1993.

The inequity of the current system is demonstrated by the experience of the Company in recent years. The Company has been in an AMT position for every taxable year since the enactment of the AMT effective for the 1987 taxable year. During 1987 through 1989, the construction of TU Electric's two-unit Comanche Peak nuclear plant (which has a tax depreciable basis of more than $8 billion) was in progress. During those years, the AMT was computed in part by making a positive adjustment for book untaxed reported profits (the "BURP adjustment"). In computing the BURP adjustment for those years, the Company was required to include in income the allowance for funds used during construction ("AFUDC"). The AFUDC represents a non-cash accounting entry which reflects the capital carrying costs for regulatory purposes incurred during large construction projects. Thus, from 1987 through 1989 (the most costly construction period in the Company's history), the Company was required to pay enormous amounts of AMT with respect to the non-cash book income represented by the AFUDC.

Effective for the 1990 taxable year, the BURP adjustment was replaced with the ACE adjustment. The ACE adjustment required an even less favorable depreciation adjustment than that required for general AMT purposes. TU Electric placed Unit 1 of the Comanche Peak station in service in 1990 and Unit 2 in service in 1993. The total tax depreciable basis of the two units exceeds $8 billion. That substantial investment resulted in an extremely large ACE adjustment by virtue of the ACE depreciation of the $8 billion investment on a straight-line basis over 20 years and a consequent extremely large annual AMT liability.

The foregoing scenario has resulted in the Company's having $450 million in accumulated AMT credit carryforwards. The Company projects that, under current law, it will be unable to use these credits for at least 10 years. This represents a prepayment of taxes in the amount of $450 million, or essentially an interest-free loan by the Company to the government in that amount. The Company, having made this interest-free loan to the government consequently has been obliged to use borrowed funds to finance its operations.

3. Policy Implications of Current Law

Many capital-intensive taxpayers such as the Company have been placed in the position of long-term AMT status with the resulting long-term interest-free loans to the government. Current law should be changed to permit these taxpayers to use the funds that they have essentially loaned to the government to finance their own operations and thereby to contribute to economic growth and job creation and to promote the ability of domestic corporations to compete in the international economy.

Surely, the current scenario is not what Congress intended when it enacted the AMT. The Company has made a legitimate $8 billion investment with the attendant job creation and contribution to the economy and has faced a steep Federal income tax penalty for doing so, a penalty that, under current law, will extend over nearly 20 years.

SUMMARY

The effect of the AMT upon the Company and other capital-intensive taxpayers has been to increase their cost of capital in the increasingly competitive domestic and international economies. The AMT therefore discourages taxpayers from making capital investments. By permitting a five-year amortization of accrued AMT credits and by conforming the AMT depreciation rules to the regular tax depreciation rules on a prospective basis as the Company proposes, Congress would take a significant step to alleviating the inequity imposed on taxpayers such as the Company whose only "fault" was substantial capital investment.

TESTIMONY OF THE UNITED STATES TELEPHONE ASSOCIATION

The United States Telephone Association ("USTA") is pleased to have this opportunity to submit testimony to the Committee on Ways and Means concerning select tax provisions contained in the "Job Creation and Wage Enhancement Act of 1995," H.R. 9. USTA is the primary trade association of local telephone companies serving more than 99 percent of the access lines in the United States and represents over 1100 members ranging in size from the regional Bell companies to the smallest of independents.

USTA supports the important underlying principle of the Contract with America -- a lessening of the role of government in the day-to-day functioning of our nation through lower taxes, less spending, fewer government regulations and a reemphasis on the importance of capital formation. With over $280 billion invested in plant and equipment and more than 530,000 employees, the local exchange industry is both capital and labor intensive. Thus, USTA has a strong interest in any proposal that seeks to lower the cost of capital to U.S. businesses and thereby encourage job creation and investment. We also endorse efforts to achieve tax relief within the overall framework of spending restraint.

We have limited our testimony to the following four Contract proposals within the Committee's jurisdiction which are of primary importance to USTA member companies: the Neutral Cost Recovery System, the new capital gains exclusion and inflation indexation concept, the initiative to increase the estate and gift tax exclusion, and the provision that would impose a moratorium on federal regulations.

Neutral Cost Recovery

As a representative of a highly capital-intensive industry, USTA has consistently advocated federal tax policies that lower the cost of capital. The Neutral Cost Recovery System ("NCRS") in the Contract is an acknowledgement that the cost of capital is too high, and it constitutes an important conceptual step toward lowering that cost. We believe that there are positive aspects to NCRS as presently structured, but we also have concerns about this approach which are detailed below.

On the positive side, under the proposal, depreciation deductions would be increased to reflect the effects of inflation and, for certain property, the time value of money. Importantly, the tax basis of NCRS property would not be decreased by these indexation factors. This is essential to the integrity of the proposal for without this provision the proposal would not achieve its stated goal of depreciating property in a manner designed to more accurately reflect a company's true economic investment.

USTA also supports the application of NCRS to the depreciation component of the alternative minimum tax ("AMT"). If NCRS did not apply for AMT purposes, the stimulative effect of NCRS would be severely diluted for the many taxpayers subject to the AMT, including some USTA members. If the incentive effect of NCRS is to be achieved, it must be applied to taxpayers in the AMT situation.

Another important consideration is the need for normalization in order for public utilities to realize the benefits of tax provisions that affect capital costs. Recognizing this, Congress has reaffirmed the concepts of normalization whenever capital formation incentives have been enacted. The NCRS system should be no exception. Without normalization protection, NCRS could actually increase the cost of capital for utility taxpayers.

The timing aspects of NCRS depreciation are protected by existing normalization provisions. However, the benefits of depreciation indexing ["indexing benefits"] are not so protected. Further, existing law might not protect against ratemaking treatments that impute elections into, or out of, NCRS. USTA strongly urges the incorporation of normalization provisions into the NCRS system. These provisions should insure that a minimum level of NCRS benefits accrues to the utility investor. To do this, the provisions must establish a ceiling on the amount of indexing benefits that may be used to reduce tax expense for the purposes of establishing cost of service for ratemaking purposes. Further, the provisions should require that each taxpayer's election of NCRS (or MACRS) must be respected for purposes of computing adjustments to deferred tax reserves under Section 168(I)(9).

USTA believes that NCRS, as presently structured, would not adequately or evenly apply to certain industries and certain types of property, potentially causing unintended distortions in competitive behavior. USTA is concerned that the proposal's annual 3.5 percent time-value-of-money adjustment would apply only to property currently amortizable under the 200 percent declining balance depreciation method (generally property with a class life of 10 years or less). Failure to allow a time-value-of-money adjustment for longer-lived assets would produce an inaccurate measure of the taxpayer's investment in such property. Further, it could have the unintended effect of discouraging investment in long-life property, which would adversely impact companies that have a high percentage of such property. Because up to 40 percent of the property of USTA members is classified as having a class life of 15 years or more, the investment incentives of NCRS would be diluted as applied to many USTA members. This effect is particularly problematic given that, under current law, competitors of USTA members, such as cable companies, are permitted to depreciate over 7 years the same type of property that USTA members are required to depreciate over 15 years. As a result, these competitors may be entitled to greater benefits under NCRS than USTA members, exacerbating the existing tax depreciation advantage they now enjoy. As technology continues to drive change in the fast-evolving telecommunications industry, this advantage could be significant in the marketplace.

The competing demands for scarce resources will cause companies in our industry to assess very cautiously the impact of electing NCRS. Despite the indexing allowances, the slower declining balance method would actually reduce a taxpayer's depreciation deductions (for 10 year or shorter-life property) relative to present law during the first several years after an asset acquisition is made, with the tax cost being recouped in later years. In fact, the need for cash flow in an increasingly competitive environment may itself be a disincentive to electing NCRS.

In order to receive the benefit of NCRS taxpayers would have to use the asset for most if not all of its class life. Because the rapid pace of technological change in our industry often produces earlier-than-planned-for obsolescence, the back-loaded benefits of NCRS could produce a tension between the need to invest in new technology and the desire to retain existing property to fully realize NCRS tax benefits. This phenomenon could actually discourage investment in new technology. Although the NCRS benefit is elective, and taxpayers could choose not to use NCRS if rapid obsolescence is expected, it is not always possible to know in advance how quickly assets will become obsolete.

USTA also is deeply concerned that a severe out-year increase in the federal budget deficit could prompt a future Congress to recoup the benefits of NCRS (not necessarily by changes in depreciation) to the detriment of companies that paid higher taxes in early years under NCRS (as a result of the switch to the 150 percent declining balance method). This result, of course, would defeat the purpose of the Contract.

USTA also would like to offer two technical suggestions for making compliance with NCRS less burdensome for companies and possibly for the IRS. First, because NCRS would require companies to apply indexation ratios on a quarterly basis, companies must make multiple, complex and time-consuming depreciation calculations each year. These calculations are especially burdensome for smaller companies that have limited access to the special computer resources needed to make these calculations. The added cost and complexity of these multiple calculations could be reduced while the incentive benefits of NCRS are maintained by permitting companies to apply annual rather than quarterly NCRS indexation ratios. Second, while USTA agrees that NCRS should apply on flexible terms -- on a property by property basis -- it believes that taxpayers should be required to affirmatively elect, rather than decline, NCRS given that the new provisions represent significant changes to the present system -- changes that some taxpayers may not be prepared (or want) to undertake. Requiring an affirmative NCRS election would prevent unwary taxpayers from having NCRS and its additional record-keeping provisions applied to their property -- an irrevocable election under the proposal.

Capital Gains

USTA strongly supports the Contract's proposed exclusion of 50 percent of capital gains from adjusted gross income as well as the indexing of capital gains for inflation. Capital investment, especially investment in our nation's technological infrastructure, must play a critical role in rebuilding our economy. The proposed capital gains exclusion and inflation adjustment would allow investors to retain more of the gains resulting from prudent capital investment, thereby lowering the cost of capital. This would, in turn, permit greater investment in the new technologies needed to compete in today's markets.

USTA has long been concerned that, under current law, capital gains resulting from inflation signify no real increase in the value of a capital asset, yet produce income that is taxable at the same rates as ordinary corporate profits. This policy compounds the problem of inflation and distorts investment behavior in the marketplace. Investors and businesses should be taxed only on real gains resulting from their capital assets and not on inflationary gains.

Consistent with our comment on the complexity of NCRS quarterly basis adjustments, we would urge Congress to simplify, to the extent possible, calculations imposed on taxpayers in this area.

Increase in the Estate and Gift Tax Exclusion

USTA also supports the proposed increase in the estate and gift tax exclusion from $600,000 to $750,000. Congress has not increased the exclusion since 1981 when the $600,000 exclusion was implemented over a 6 year phase-in period that ended in 1987 when the $600,000 threshold was reached. There has been substantial inflation over the period since then, eroding the real value of the exclusion and resulting in a de facto increase in estate and gift taxes. Increasing the exclusion to $750,000 is long overdue. For many of our smaller companies, this exclusion can mean the difference between retaining a family-owned and operated business and being forced to sell to satisfy estate taxes. We believe that indexing the exclusion permanently is consistent with other Contract tax proposals and an important improvement over current law, and we applaud its inclusion.

Moratorium on Federal Regulations

USTA would like to request that Congress not extend the proposed general moratorium on regulations to those tax regulations published by the Treasury Department. Such regulations provide needed guidance and certainty to taxpayers dealing with the Internal Revenue Code and, unlike most regulations, are generally encouraged by U.S. companies. Extending the moratorium to Treasury regulations would create uncertainty and prevent economically advantageous financial transactions from taking place. It would put undue pressure on the system of obtaining private letter rulings in the absence of timely regulations of general application. It also would limit the ability of the Treasury to fight abusive transactions -- something that clearly is in the public interest. We therefore agree with the Treasury Department that income tax regulations should be exempted from the moratorium.

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In conclusion, the authors of the Contract should be praised for placing emphasis on the need to lower the cost of capital for U.S. businesses. Given the increasingly global competition we face, this is an essential policy imperative. And while USTA would like to restate its support for the Contract's objective of reducing the role of government in our lives through tax relief and regulatory reform, we also endorse the Contract's objective to obtain significant spending reductions.

Thank you for this opportunity to present testimony. We would be pleased to discuss these views with members and committee staffs at their convenience.

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